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Global Markets Research

ANCHOR REPORT

Asia 2016 outlook – Choppier seas ahead

- Asia's growth slowdown looks structural to us, because of an outsized late-stage financial cycle, disproportionately high exposure to China, and demographic challenges that are starting to bite. A Fed hiking cycle heightens the already non-trivial risk of a credit crunch in the region. Our league table has laggards (China, Hong Kong, Korea, Singapore, Taiwan and Thailand) outnumbering leaders (India, the Philippines), 6 to 2.
- **FX strategy:** We expect Asia FX to depreciate versus USD. Long USD/KRW should offer the highest total return in 2016. We also recommend long USD against TWD, CNH and HKD. We look for some outperformance of INR and PHP in the region in 2016, while into Q1 2016, we expect short SGD/MYR to perform.
- **Rates strategy:** We like long 5yr CNH CGB and long 5yr IGB positions. We expect steeper yield curves in KRW, MYR, THB and HKD. We also like SGD flatteners and short-end AUD flattening.
- **Equity strategy:** Our end-2016 MSCI APXJ index target of 465 offers 8% upside. Top-down, we stick with capital-abundant, low-yielding and/or downstream cyclicals; bottom-up, we reduce leverage to bolster portfolio resilience versus potential adversity.

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Asia's growth slowdown looks structural to us. Despite the halving of oil prices and interest rates at, or near, record lows in most countries, trend growth in Asia ex-Japan slowed for a fifth straight year in 2015. The choppy seas we foresaw in 2015 are likely to get choppier in 2016. We forecast Asia-ex Japan GDP growth to slow further to 5.7% in 2016. That would be its slowest pace since 1998, heightening the already non-trivial risk of credit crunches. Asia faces three main structural headwinds:

1. China. The rubber has hit the road: severe overcapacity in the property sector and upstream industries; excessive and still-rising leverage; diminishing returns on capital and a shrinking working-age population are all simultaneously bearing down on China's economy. We are at the bottom of consensus, forecasting a full percentage point slowdown in reported GDP growth, to 5.8% in 2016. China's investment-led slowdown is disproportionately hurting the rest of Asia more than other regions, simply because the trade and financial linkages are much stronger than they are elsewhere.

2. Demographics. Asia's demographic challenges have crept up faster than most people realise. Working-age populations are either shrinking, or on the cusp of shrinking, in China, Hong Kong, Korea, Taiwan and Thailand. Recall that potential output growth is made up of three factors: labour, capital and how efficiently these two inputs are used, or total factor productivity (TFP). TFP growth is weak across Asia, and now with little or no contribution to GDP growth from labour in half of the major economies in the region, it is hard for us to envisage a strong, sustained rebound in Asia's GDP growth any time soon.

3. Financial cycle. We believe that Asia's outsized financial cycle, in terms of excessive debt and elevated property prices, is at a late stage where the negative side effects – rising debt-servicing costs, misallocated capital and weaker productivity – are reducing policy efficacy and crimping growth. In measuring the vulnerability of Asia's economies, we find that the region scores well (i.e., low vulnerability) for balance of payments and idiosyncratic risks (e.g., politics), but Asia is on average over 4x more exposed to financial imbalances and over 2x more exposed to China than other major EMs. We believe that balance of payments and idiosyncratic risks are better understood – and priced – by markets than the latent risks from financial imbalances and China exposure. At some point, Asia's outsized financial cycle will reverse – be it gradually or abruptly. The latter should not be dismissed lightly, given a Fed hiking cycle and liquidity illusion.

In assessing the economic outlook for both growth and fundamentals, our league table for Asia has laggards (China, Hong Kong, Korea, Singapore, Taiwan and Thailand) outnumbering leaders (India and the Philippines), 6 to 2. In the middle we have Indonesia and Malaysia. In most countries we expect CPI inflation to rise modestly in 2016, but central banks are likely to look through this given it is starting from a low level and is not demand-driven. We expect a major decoupling from past Fed hiking cycles, with the central banks of China, Indonesia, Korea, Taiwan and Thailand cutting rates further. We also expect fiscal policy to be noticeably more stimulatory in 2016 than in 2015. That said, demand-management policies can only do so much to support growth against structural headwinds. The focus urgently needs to shift to supply-side reforms – but here we are not optimistic. The simple truth is that deregulation and market-opening reforms often involve short-term adjustment costs, and that is something politicians have little appetite for when growth is weak.

Our high conviction and out-of-consensus calls for 2016 are:

- **China:** We are at the bottom of consensus, forecasting 5.8% GDP growth in 2016, but it is not a hard landing as unemployment does not rise sharply.
- **Korea:** We are out of consensus, forecasting the Bank of Korea to cut rates by 25bp in February and June, whereas the market is pricing no cuts.
- **India:** By March 2017, we expect CPI inflation to be nearly a full percentage point above the Reserve Bank of India's 5% target. We see no room for rate cuts in 2016.
- **Indonesia:** Given the prospect of more expansionary macro policies and a more favourable outlook on reforms, we recently raised our GDP growth forecasts above consensus, to 5.2% in 2016 and 5.6% in 2017.

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Based on global and local factors, including: 1) downside risks to China's economy and RMB depreciation; 2) Fed rate hikes and USD strength in G3; 3) Asian monetary policy loosening; 4) politics and policy concerns and; 5) Nomura's assumption of low commodity prices, but some upward pressure on food prices, our key recommendations into 2016 include:

- **Long USD/KRW** (target spot at 1230, total return of 5.6% by Q2 2016).
- **Long USD/TWD** (target spot at 33.9, total return of 3.5% by Q2 2016).
- **Short USD/INR** (target spot at 67.2, (total return of 2.9% by Q2 2016).
- **Short USD/PHP** (target spot at 47.6, total return of 0.4% by Q2 2016).
- **Short SGD/MYR** (target spot SGD and MYR at 1.45 and 4.23 respectively, total return of 3.1% by Q1 16).
- **Long USD/CNH** (target spot at 6.65, total return of 1.4% by Q2 16).
- **Long 12M USD/HKD** (target spot at 7.80, total return of 0.7% by Q2 16).

Rates strategy

We believe that local factors will be prominent drivers of rates markets in 2016 and hence suggest investors take a selective approach to Asia rates markets. Key factors forming our view are: monetary policy divergence from the US; higher term premia in select Asian countries; a gradual Fed hiking cycle amid slower global growth; and local and liquidity dynamics in China and India. Our key recommendations into 2016 are:

- **China**: Long 5yr CNH CGBs; look to receive the front-end of the swap curve.
- **India:** 1s5s, 2s5s NDOIS flatteners and long 9yr IGBs into Q1 2016; look to enter long 5yr IGBs and long 5yr bond vs 5yr swap spread.
- **Korea**: 3s10s and 2s5s swap steepeners; look to enter 1yr outright receivers.
- **Thailand**: 3yr swap receivers and 2s5s steepeners.
- **Malaysia**: Receive 1s3s10s / 1s2s5s (steepeners); look to initiate receive 2yr and 3yr.
- **Singapore**:2s5s flatteners; receiving 2s5s10s / 3s5s10s fly
- **Hong Kong**: Pay 10y swap and 2s5s IRS steepeners.
- **Australia**: 3m fwd1s3s swap flatteners.

Equity strategy

We expect slightly above-consensus Asia-Pacific ex-Japan EPS growth of 7-8% to deliver the MSCI regional equity benchmark to an end-2016 target of 465 (roughly 8% above our end-2015 assumption of 430). In assessing country- and sector-level risk and opportunity in 2016, many of the past year's key macro drivers will remain centre-screen: China's moderating investment demand; a shallow but ongoing *pickup* in global Nominal GDP led by the Developed Markets; anticipation of higher US interest rates; US dollar gains; and a heavy energy- and commodity-price environment. Thus many of our key top-down fundamental preferences by Asia-Pacific country and sector also remain unchanged into the new year — namely an emphasis on capital-abundant, cyclically sensitive, low-yielding and/or downstream plays at the expense of capital-poor, low-cyclical, high-yield and/or upstream ones. Our main Overweights remain Taiwan, Korea and India; and the Tech, Industrials, Discretionary and Banks & Insurance sectors. Key Underweights include Australia, Hong Kong, Malaysia and Thailand; and the Telco, Staples, Property, and *upstream* Energy and Materials spaces.

In terms of bottom-up stock selection, despite still-strengthening global nominal demand, rising risks of a regional 'credit crunch' also suggest a prudent dialling down of *leverage* as well as increased emphasis on *quality* in order to bolster portfolio resilience to such potential shocks – in the context of a *still* cyclical/growth-focused approach. Our basket of 26 regional 'Top Picks' for 2016 thus are chosen for their healthy balance sheets and proven profitability & governance, featuring an average Net-Debt/Equity ratio (ex-Financials) of *negative* -9% (i.e. net cash), a robust average Altman Z-score of 7.1, and average ROE of no less than 18.3% (fully 7pp higher than the region-wide average). The basket's pedestrian beta of 0.9x means, in essence, that we are trading away some potential upside sensitivity in order to gain resilience vs. potential adversity; but our 26 'Top Pick' stocks still enjoy 30% average upside to Nomura analyst target prices.

Forecast summary

Fig. 1: Summary of forecasts

	Real GDP			Official Policy Rate			Currency		
	2015	2016	2017	2015	2016	2017	2015	2016	2017
United States	2.5	2.2	2.0	0.25-0.50	0.75-1.00	1.50-1.75			
Euro Area*	1.5	1.4	1.5	0.05	0.05	0.05	1.05	1.00	1.00
Japan	0.6	1.2	0.5	0.07	0.07	0.07	125	130	135

	Real GDP			Consumer Prices		
	2015	2016	2017	2015	2016	2017
Australia	2.3	2.4	2.4	1.5	2.1	2.3
China	6.8	5.8	5.6	1.4	1.9	2.0
Hong Kong	2.4	2.3	2.9	3.0	2.5	3.0
India	7.3	7.8	8.0	4.9	5.8	5.8
Indonesia	4.7	5.2	5.6	6.4	4.7	4.8
Malaysia	5.0	4.0	4.1	2.2	4.0	2.0
Philippines	5.8	6.5	5.8	1.4	2.7	3.5
Singapore	1.8	1.8	1.8	-0.5	-0.1	0.2
South Korea	2.5	2.5	2.7	0.7	1.5	2.0
Taiwan	1.2	2.4	2.6	-0.4	0.7	0.9
Thailand	2.7	2.5	2.7	-0.8	1.2	0.9
Asia ex-Japan, Aust	6.1	5.7	5.7	2.4	2.9	3.0

	Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2015	2016	2017	2015	2016	2017
Australia	-4.1	-4.0	-3.3	-4.0	-3.9	-3.1
China	2.5	3.2	3.0	-2.8	-3.0	-3.0
Hong Kong	3.1	2.7	2.3	1.3	1.0	2.0
India	-0.9	-1.3	-2.1	-3.9	-3.6	-3.3
Indonesia	-1.9	-2.3	-2.8	-2.6	-2.7	-2.5
Malaysia	2.8	2.7	2.7	-3.2	-3.1	-2.8
Philippines	4.0	3.3	2.8	-0.7	-2.0	-2.3
Singapore	24.0	22.0	20.0	-1.0	-0.2	1.5
South Korea	8.8	8.4	6.0	0.5	0.4	1.0
Taiwan	12.6	10.4	11.2	-1.5	-2.0	-2.0
Thailand	6.6	4.1	3.9	-2.4	-2.3	-2.5
Asia ex-Japan, Aust	2.5	2.5	2.0	-2.7	-2.8	-2.7

	Official Policy Rate			Currency per US Dollar		
	2015	2016	2017	2015	2016	2017
Australia	2.00	1.75	2.25	0.70	0.67	0.69
China	1.50	1.00	1.00	6.45	6.80	6.79
Hong Kong	0.65	1.15	1.90	7.75	7.82	7.81
India	6.75	6.75	6.75	66.7	67.4	65.0
Indonesia	7.50	7.00	6.50	14000	14850	14600
Malaysia	3.25	3.25	3.50	4.20	4.40	4.28
Philippines	4.00	4.50	5.00	47.1	48.1	46.8
Singapore	1.30	1.80	2.55	1.42	1.50	1.46
South Korea	1.50	1.00	1.25	1170	1250	1210
Taiwan	1.63	1.63	1.75	32.9	34.2	33.3
Thailand	1.50	1.00	1.00	36.1	38.0	38.0

Note: *Currency for the Euro Area refers to USD/EUR. All figures relate to the modal forecast, I.e., the "most likely" outcome. For Hong Kong and Singapore, the policy rate refers to the three month interbank rates of HIBOR and SIBOR, respectively. For China, it refers to the one-year bank deposit rate. Fiscal balances are for fiscal years which differ from calendar years for Hong Kong (Apr-Mar), India (Apr-Mar), Singapore (Apr-Mar) and Thailand (Oct-Sep). Fiscal data are for the central government and do not include off-budget.
Source: CEIC, Bloomberg, Nomura.

Choppier seas ahead

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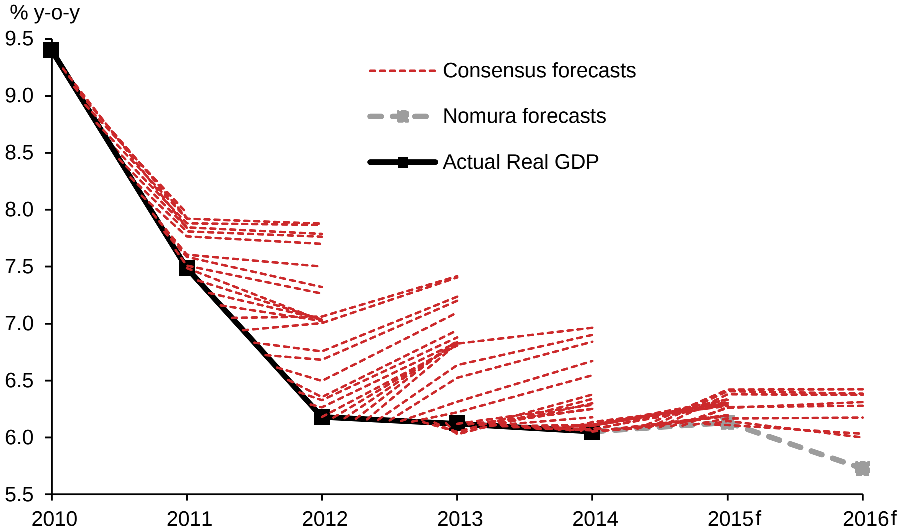
We entitled our Asia 2015 outlook, *Choppy seas ahead*, and warned that "the spillovers from a continued China slowdown, a weaker yen and Fed rate hikes could expose Asia's Achilles heel – financial imbalances". In retrospect, the Fed stood pat (at least so far) and the yen was quite stable, yet our cautious view on Asian growth proved prescient. Trend growth in Asia slowed for a fifth straight year, despite the halving of oil prices and interest rates cut to reach, or approach, record lows in most countries.

This smacks of something more structural, as does the consensus forecast systematically over-predicting Asian growth (Figure 2). We believe that Asia's outsized financial cycle, in terms of excessive debt and elevated property prices, is at a late stage where the negative side effects – higher debt-servicing costs, misallocated capital and weaker productivity – are reducing policy efficacy and crimping growth. Add to this our views that: 1) China's reported growth will slow more sharply in 2016, to 5.8%; and 2) Asia's demographic challenges have crept up faster than most people realise, with the working-age population either shrinking, or on the cusp of shrinking, in China, Hong Kong, Korea, Taiwan and Thailand. Throw into the mix a likely Fed hiking cycle and USD appreciation, and our outlook compared to a year ago paints a picture of even *choppier seas* ahead. There could be a brief EM relief rally after a Fed lift-off and there are a few countries where we are positive (India and the Philippines) or becoming more constructive (Indonesia), but overall we forecast Asia-ex Japan GDP growth to slow to 5.7% in 2016. That would be its slowest pace since 1998, heightening the already non-trivial risk of credit crunches or worse, financial crises.

Fig. 2: Asia ex-Japan's real GDP: the consensus is perennially too optimistic



Note: We take the one-year- and two-year-ahead consensus forecasts each month for China, Hong Kong, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand. Asia ex-Japan growth is a GDP (in PPP terms)-weighted average of these forecasts. The consensus being perennially optimistic is broad-based across these countries; individual country results are available upon request. Source: Consensus Economics Inc., CEIC and Nomura Global Economics.

Before delving into these issues, some words on our global outlook. Our house view has five key elements: 1) real GDP growth in the advanced economies in 2016 remains mediocre and uneven, led by the US at 2.2%, with the euro area and Japan lagging at 1.4% and 1.2%, respectively; 2) we expect a Fed lift-off this month, but with a US hiking cycle that is slower and much shallower than in the past – in 2016 we forecast only two 25bp rate hikes coming in June and Q4; 3) the European Central Bank (ECB) and Bank of Japan (BOJ) increase their quantitative easing (QE) efforts; 4) USD continues its appreciation trend and ends 2016 at 130 against JPY, 1.00 against EUR and 6.80 against RMB; and 5) the price of oil and most hard commodities remains near current low levels, but the severe El Niño could lift food prices.

China – where the rubber hits the road

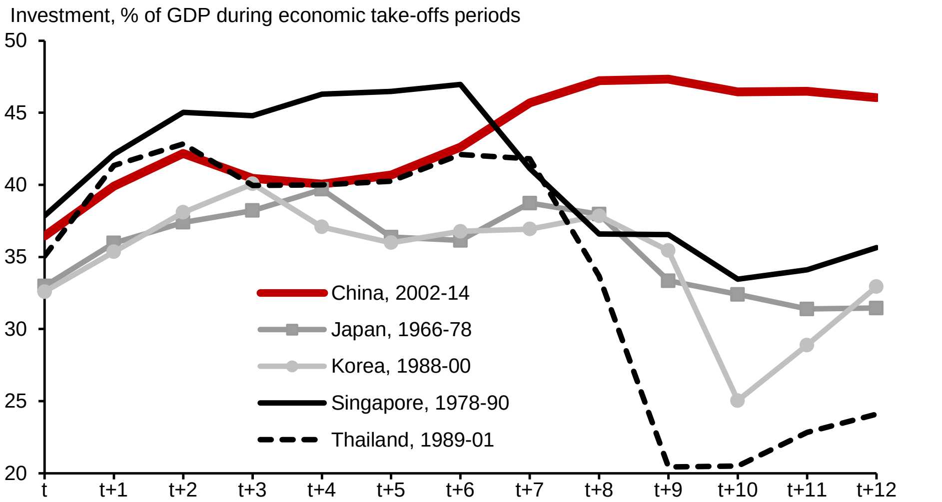
China's economy has reached the point where the rubber hits the road: severe overcapacity in the property sector and upstream industries; excessive and still-rising leverage; diminishing returns on capital and a shrinking working-age population are all simultaneously bearing down on the economy. In short, China has "borrowed" growth from the future. We are at the bottom of consensus, forecasting a slowdown of *reported* GDP growth from an estimated 6.8% this year to 5.8% in 2016, led by investment.

Compared to other major economies, China has more room to ease policies, further potential gains to unlock from structural reforms and greater state control. However, the counterfactual is critical here: if not for these endowments, China, in our view, would have had a sharper growth slowdown, and with the rubber now hitting the road, they are likely to provide less of a buffer over the next few years. First, consider policy easing. In 2016, we forecast four more 50bp reserve requirement ratio (RRR) cuts, two more 25bp interest rate cuts and a mildly expansionary fiscal policy, yet we expect GDP growth to slow to below 6% because monetary policy is losing its effectiveness amid high leverage, and viable public infrastructure projects are more limited given large-scale overcapacity.

On reforms, they take time and if China is to move to a new, sustainable growth model, the most critical ones – restructuring state-owned enterprises (SOEs) and getting banks to properly price credit risk to stamp out moral hazard – have unsurprisingly been left to last, since they are the most painful in the short run. On state control, we would argue that it is at the root of many of China's increased vulnerabilities. As companies and investors become more sophisticated, administrative measures are easier to evade; instead, market forces need to play a greater role in allocating credit and capital efficiently – and judging from the great strides made in market-opening reforms and the anti-corruption drive, China's authorities understand this. But it is a chicken and egg problem: markets expose vulnerabilities. China has left financial liberalisation until late in the game, when its growth is slowing and its fundamentals are weak. The turbulence that China markets experienced this year is likely to continue until things change, increasing investor uncertainty (not to mention risk aversion) and weighing on growth.

Importantly, we do not regard our 5.8% growth forecast as constituting a hard landing, whereby unemployment becomes a serious problem. The level of GDP growth at which unemployment climbs has been declining each year, in line with a slowing potential growth rate. Rather, our narrative is that the slower growth we forecast is *safer* growth and the silver lining is that economic rebalancing to consumption and services (away from investment) is making headway, underpinned by policies to beef-up social welfare and redistribute income from companies to households. That said, we are cognisant of the non-trivial risk to our base case of a hard landing and much faster rebalancing, perhaps triggered by a snowballing of corporate credit defaults or a mass exodus of capital. We are mindful that China's investment share of GDP has been above 40% for 12 straight years – an extraordinarily long time (Figure 3).

Fig. 3: Investment to GDP ratios during take-off periods



Note: t=no of years from the starting year (e.g., China = 2002). Data are in nominal terms and investment is the sum of public and private gross capital formation. Source: China Statistical Yearbook, CEIC and Nomura Global Economics.

In other countries that have had high investment rates, it was not uncommon for these periods to be followed by an outright fall (i.e. growth turn negative) in investment. This brings to bear China's challenging GDP arithmetic: at close to half of GDP, if China's investment was to fall, consumption would have to somehow escape any spillover effects and really boom to avert a hard landing.

At the Fifth Plenum in October, the government essentially set a GDP growth target of 6.5%, on average, over 2016-20, and while this does not rule out sub-6% growth in any single year, it does pose a risk to our forecast. The government could implement a 2008-style mega-stimulus, but we judge this as unlikely as it would create even bigger bubbles and increase the risk of a hard landing further out. An alternative would be to window-dress reported GDP, but this would be a dangerous strategy too. From bottom-up company analysis and private surveys, to trade data and capital flows, it is too hard to hide the reality on the ground. There is already a great deal of scepticism on China's reported GDP growth rates, so going down this route could quickly undermine policy credibility and increase the chances of policy mistakes.

China's investment-led slowdown is disproportionately hurting the rest of Asia's economies more than any other region, simply because the trade and financial linkages are much stronger than elsewhere. In terms of the value-added share of GDP embodied in China's final demand, Hong Kong is 17x that of the US, Taiwan 14x, Malaysia 12x, Singapore 9x, Korea 8x and Australia 6x. It is quite plausible that a continued China slowdown will hurt several other Asian economies – such as Hong Kong, Singapore, Taiwan and possibly Korea – more than China itself, given China's greater room for policy responses, while its consumption and service sectors are likely to provide larger offsets.

Asia's weak productivity amid demographic challenges

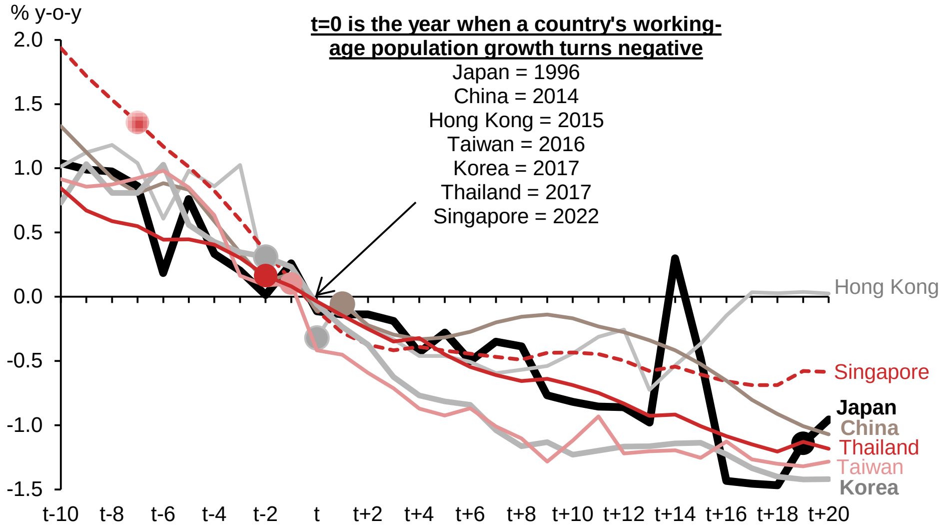
At the core of our cautious outlook is that China is only one of several factors behind Asia's structural slowdown and the 13 risks we identify are stacked to the downside as well (see *Box 1: Risks around our 2016 outlook*).

There has been a noticeable slowdown in total factor productivity (TFP) growth across Asia. The US Conference Board has a worldwide database on TFP and for Asia it shows that in all countries except the Philippines productivity growth has weakened since the global financial crisis. Of course, the productivity slowdown has been a worldwide phenomenon, but outside Asia it can be at least partly attributed to hysteresis and other long-lasting scars from the financial crisis. In Asia, the productivity slowdown seems to have more to do with cheap credit keeping zombie companies alive, misallocating investment (e.g., property market speculation) and reducing the incentive for supply-side reforms. Productivity gains in the tradable sector could also be fading, as Asia's vertical supply chain has reached a mature stage, to the point that there is increasing talk of on-shoring of US manufacturing and China import substitution.

It is disconcerting that TFP growth is slowing at a time when Asia's demographic challenges are starting to bite. Focussing on the working-age population, which we define as the 15-64 age cohort, it is well known that it started to fall in Japan a long time ago (1996), and lately has been declining at an annual rate of 1.5%. However, far less appreciated is how ageing populations and low fertility rates are rapidly starting to impact the rest of Asia. In half of Asia's major economies, the growth rate of the working-age population has slowed markedly in recent years. It turned negative in China in 2014, Hong Kong in 2015, and based on local official projections, it is set to do so in Taiwan in 2016 and Korea and Thailand in 2017 (Figure 4; the dots indicate the year 2015). Also striking is the speed of the future decline: the working-age populations of Korea and Taiwan reach a 1% annual rate of decline after only eight years of turning negative; in Japan, it took 14 years. Recall that potential output growth is made up of three factors: labour, capital and how efficiently these two inputs are used, or TFP.

Against a backdrop of weak TFP growth and little or no contribution to GDP growth from labour in many countries, it is hard for us to envisage a strong, sustained rebound in Asia's GDP growth any time soon.

Fig. 4: Demographics are starting to matter: working-age (15-64) population growth



Note: t is years and t=0 is the year when the working-age population of each respective country turns negative. Dots refer to the country's working age population growth in 2015. Japan introduced online questionnaires in its 2010 census (Year t+14), which led to an increase the number of young respondents. This explains the sharp spike in Japan's reported working age population growth in that year (t+14). Source: United Nations Population Division, Ministry of the Interior (Taiwan), National Development Council (Taiwan), National Bureau of Statistics (China), Census and Statistics Department (Hong Kong), Statistical Bureau (Japan), Statistics Korea, CEIC and Nomura Global Economics.

Asia's outsized, late-stage financial cycle

Driven primarily by monetary policies in advanced economies – notably QE – financial conditions in Asia have been very loose for a very long time. Asian central banks cut policy rates to near record lows in 2009 and most remain around these levels today. The fear has been that raising rates would lead to excessive Asian currency appreciation when exports are weak. In addition, large-scale bond purchases by the Fed, ECB, BOJ and BOE have pushed foreign investors into Asia's comparatively illiquid bond markets, driving down local yields and encouraging Asian companies to issue more foreign-currency debt. Overall, QE has shifted Asia's entire yield curve lower. Unsurprisingly, persistently low rates have fuelled Asia's outsized financial cycle which now appears to be in a late stage, with debt-servicing ratios rising.

Empirical studies show that the ratio of private credit to GDP is the single-best early warning indicator of financial crises. This ratio has risen to over 100% in Thailand, Malaysia and Singapore, to over 150% in Taiwan and Korea, and to around 200% or higher in China and Hong Kong. These ratios are not only high, but have built up rapidly and fuelled overheated property markets. The rise has been mostly due to corporate borrowing, but household debt has also risen to high levels in Korea, Malaysia and Thailand. In most countries, credit still outpaces nominal GDP, and so the ratio continues to rise.

There has been considerable research on quantifying the risk of financial crises. Here we adopt the latest techniques used by the Bank for International Settlements (BIS). In addition to the credit ratio, we calculate the credit gap, which is the credit ratio's deviation from its long-run trend, and also a real property price gap (real residential property price percent deviation from its long-run trend). The critical thresholds for each 'gap' are drawn from the BIS, which found that a credit gap of more than 10% predicted two-thirds of past financial crises, and a property gap of more than 10% predicted about three-quarters of crises. Moreover, the BIS found that when the credit and property gaps are both jointly above 10%, the noise-to-signal ratio is very low, indicating highly accurate predictions.

Figure 5 is our scorecard approach to assessing the vulnerability of Asia's economies and 10 other EMs. For the five main risk categories, whenever the vulnerability indicators breach critical thresholds we assign scores from 10 (most) to 0 (least vulnerable). The overriding result is that once the financial cycle and exposure to China are taken into account, Asia's economies are, on average, more vulnerable than the other 10 EMs, led in order, by Hong Kong, Taiwan, Malaysia, Singapore, Thailand and Indonesia (and this is robust to moderate changes in the thresholds). Asia is on average over 4x more exposed to financial imbalances and over 2x more exposed to China than the other EMs, whereas Asia scores well (i.e., low vulnerability) for balance of payments and idiosyncratic risks (e.g., politics) and has a bit more scope for policy responses than other EM.

Box 1: Risks around our 2016 outlook

Downside risks

1. A credit crunch in emerging markets (high). In EM, there has been a significant build-up of domestic and, in some countries, foreign-currency debt. USD appreciation and Fed rate hikes could be catalysts for increased corporate defaults, which, in turn, could lead investors to reassess the EM risk-return trade-off (see #4).

2. (Geo)politics (high). On top of major risks outside Asia, there are many within: North Korea, maritime border disputes with China and a rise in political uncertainty in 2016 in Thailand (self-imposed military government), legislative elections in Hong Kong (September), Korea (April), the Philippines (May) and Taiwan (January). Also, the terms of the central bank governors of Malaysia and India end in May and September, respectively.

3. A China hard landing (medium). A snowballing of corporate defaults or a mass exodus of capital are two possible triggers. We are also mindful of China's challenging GDP arithmetic. At 46% of GDP, if China's investment was to fall – and this is not uncommon for countries that have had debt-fuelled investment booms – mathematically, it would be hard to avoid a hard landing absent a simultaneous quixotic boom in consumption.

4. Liquidity illusion (medium). If global asset managers reduce their exposure in Asia as global banks warehouse less risk than before, liquidity could quickly vanish, causing exaggerated price moves that set off corporate defaults and a vicious spiral.

5. Currency war (medium). We believe that, over time, China will let its currency be more market-determined, and given the economy's slowing growth and weak fundamentals, we cannot rule out significant RMB depreciation. This could spark beggar-thy-neighbour currency depreciations across Asia.

6. El Niño (medium). The current severe El Niño raises the risk of a surge in food prices that could fan higher-than-expected inflation. It could also escalate geopolitical risks, as many countries most vulnerable to a surge in food prices are the ones on tenterhooks – Syria, Libya, Egypt, Nigeria and Kazakhstan.

7. A sharp rise in US inflation (medium). At some point, inflation could accelerate and/or financial imbalances could become excessive, forcing the Fed to hike more aggressively. This could be destabilising for Asia if US bond yields and USD rise sharply amid mediocre US growth.

8. Asian deflation (low). Absent a surge in food prices, it is possible for oil prices to fall further which, together with weak demand, could place growing pressure on Asian companies to cut prices to stay competitive. Deepening deflation raises real interest rates, but can also lead to a debt-deflation loop, given the high leverage in the region.

Upside risks

1. Discrimination by global EM investors in favour of Asia (medium). If the global search for yield intensifies (see #4), and if, in the short run, markets continue to focus more on balance of payments vulnerability indicators rather than financial imbalances, then this would favour Asia over most other EM.

2. A China high-quality growth slowdown via rebalancing (medium). This requires accelerated reforms to transform the economy from one driven by investment, exports, SOEs and vested interests to one that is driven more by market forces, consumption, services and innovative private enterprises.

3. Asia steps up fiscal stimulus and reforms (medium). Compared to other regions, Asia has ample room for more fiscal stimulus. However, for the stimulus to be effective in lifting investor confidence, it needs to occur in parallel with a pick-up in supply-side reforms, including relaxing FDI restrictions, deregulating labour markets, opening up services sectors and beefing-up hard and soft infrastructure spending.

4. Fed lift-off delayed, while BOJ and ECB step up QE (low). A lengthy delay in Fed lift-off for market-friendly reasons (i.e., US inflation falls while growth remains above 2%), and the BOJ and ECB step up QE (due to deflation risks) would boost global liquidity, intensify the search for yield and rejuvenate capital inflows to higher-yielding EM.

5. A robust recovery in foreign demand (low). A stronger-than-expected US economic expansion spreads and leads to a synchronised recovery in the advanced economies and a rebound in oil prices. This, in turn, underpins some of the world's major commodity producing economies. All this eventually leads to a major turnaround in Asian exports.

We believe that balance of payments and idiosyncratic risks are better understood – and priced – by markets than the latent risks from financial imbalances and China exposure. It is also a misconception that a strong balance of payments insulates a country from domestic financial crises. Some of the most spectacular financial crises have occurred in current account surplus countries – the US before the Great Depression and Japan in the late 80s – and there are limits to how far FX reserves can be mobilised to bail out the corporate sector. Moreover, even if there is ample room for policy easing, it may be unable to short circuit a crisis, as many advanced economies learned in 2008.

Fig. 5: Vulnerability scorecard: Asia versus 10 other EM

	Financial imbalances				China exposure				Idiosyncratic factors				Balance of payments resilience				Room for policy response				
	Private credit	Private credit gap	Real property price gap	SCORE	Exports to China	Non-food commodity exports	Equity & FX correlation with China	SCORE	Real GDP growth	Real GDP growth deviation from 5yr average	CPI inflation	SCORE	Current account	External debt	FX reserves /imports	SCORE	Fiscal balance	Public debt	Policy rate	SCORE	TOTAL SCORE
	% GDP	% deviation	% deviation		% GDP	% goods exports	Ratio		% y-o-y	pp	% y-o-y		% GDP	% GDP	Ratio		% GDP	% GDP	%		
China	198.2	14.9	15.6						6.8	-1.0	1.4		2.5	18.6	24.8		-1.9	43.2	1.50		
Hong Kong	292.4	18.4	29.5		87.8	7.1	0.6		2.4	-0.5	3.0		3.1		7.8		3.5	0.0	0.39		
India	60.0	-4.5	7.2		0.6	40.3	-0.1		7.3	0.7	4.9		-0.9	24.8	9.8		-7.2	65.3	6.75		
Indonesia	39.3	13.5	15.3		2.0	41.5	-0.1		4.7	-0.8	6.4		-1.9	35.7	7.7		-2.3	26.5	7.50		
Malaysia	134.8	6.5	12.8		11.1	30.0	0.4		5.0	-0.3	2.2		2.8	71.2	5.5		-3.5	55.6	3.25		
Philippines	39.2	18.5	1.5		4.5	12.6	0.5		5.8	-0.1	1.4		4.0	26.3	12.7		-0.1	35.9	4.00		
Singapore	141.8	16.0	-7.1		18.1	20.7	0.8		1.8	-2.0	-0.5		24.0		9.7		1.1	0.0	1.08		
Korea	190.4	1.8	6.2		11.6	19.8	0.0		2.5	-0.4	0.7		8.8	30.1	9.7		-0.5	38.2	1.50		
Taiwan	162.6	-0.8	12.3		21.6	17.7	0.6		1.2	-1.4	-0.4		12.6	34.7	21.8		-1.5	38.9	1.75		
Thailand	121.0	15.8	16.0		7.6	16.1	0.4		2.7	-0.2	-0.8		6.6	34.4	8.3		-1.2	43.5	1.50		
Brazil	76.1	25.1	-4.9		1.7	45.8	0.3		-3.0	-4.1	10.3		-3.5	22.6	23.1		-7.7	69.9	14.25		
Chile	79.4	4.3	9.3		7.1	64.4	-0.3		2.2	-1.7	4.5		-1.0	56.6	7.4		-3.3	18.1	3.25		
Colombia	42.8	23.0	-1.8		1.5	72.0	0.0		2.6	-1.9	4.9		-6.0	32.5	9.3		-3.1	50.9	5.50		
Hungary	109.2	-18.8	-5.9		1.2	10.3	0.0		2.9	1.2	0.0		5.0	159.0	4.5		-2.7	75.3	1.35		
Mexico	37.5	18.0	-4.0		0.5	17.8	-0.2		2.6	-0.2	2.7		-2.7	35.0	5.0		-4.0	52.0	3.00		
Poland	81.9	-0.5	4.6		0.4	18.4	-0.1		3.5	0.5	-0.9		-0.3	74.2	6.0		-2.8	51.1	1.50		
Romania	30.9	-25.6	23.2		0.4	18.3	-0.1		3.5	1.2	-0.7		-0.1	58.9	6.2		-1.8	40.9	1.75		
Russia	75.5	8.3	-29.2		2.0	81.9	0.0		-3.8	-5.0	15.5		5.1	44.7	19.0		-5.7	20.4	11.00		
S. Africa	71.8	-2.5	-7.2		2.5	49.2	-0.2		1.3	-0.8	4.6		-4.3	48.2	5.1		-4.1	48.4	6.25		
Turkey	77.4	26.2	4.3		0.4	21.8	-0.2		3.5	-0.8	7.6		-5.1	52.3	5.5		-0.8	32.1	7.50		
ASIA	**138.0**	**10.0**	**10.9**		**18.3**	**22.9**	**0.4**		**4.0**	**-0.6**	**1.8**		**6.2**	**34.5**	**11.8**		**-1.4**	**34.7**	**2.92**		
OTHER EM	**68.2**	**5.8**	**-1.2**		**1.8**	**40.0**	**-0.1**		**1.5**	**-1.2**	**4.9**		**-1.3**	**58.4**	**9.1**		**-3.6**	**45.9**	**5.54**		
Vulnerability score (higher score = more vulnerable)																					
China	3	2	2	**10**					0	2	0	**2**	0	0	0	**0**	0	0	2	**2**	**14**
Hong Kong	3	2	2	**10**	3	0	3	**7**	0	0	0	**0**	0		0	**0**	0	0	3	**3**	**20**
India	0	0	1	**1**	0	2	0	**2**	0	0	0	**0**	1	0	0	**1**	3	2	0	**5**	**9**
Indonesia	0	2	2	**7**	0	2	0	**2**	0	1	1	**2**	1	1	0	**2**	1	0	0	**1**	**14**
Malaysia	2	1	2	**5**	3	1	2	**6**	0	0	0	**0**	0	3	2	**5**	1	1	0	**2**	**18**
Philippines	0	2	0	**2**	1	0	3	**4**	0	0	0	**0**	0	0	0	**0**	0	0	0	**0**	**6**
Singapore	2	2	0	**4**	3	1	3	**8**	1	2	0	**3**	0		0	**0**	0	0	2	**2**	**17**
Korea	3	0	1	**4**	3	1	0	**4**	0	0	0	**0**	0	1	0	**1**	0	0	2	**2**	**11**
Taiwan	3	0	2	**5**	3	1	3	**8**	1	2	0	**3**	0	1	0	**1**	0	0	2	**2**	**19**
Thailand	1	2	2	**8**	2	1	2	**5**	0	0	0	**0**	0	1	0	**1**	0	0	2	**2**	**16**
Brazil	0	2	0	**2**	0	2	1	**3**	3	3	2	**9**	2	0	0	**2**	3	2	0	**5**	**21**
Chile	0	0	1	**1**	2	3	0	**5**	0	2	0	**2**	1	3	0	**4**	1	0	0	**1**	**13**
Colombia	0	2	0	**2**	0	3	0	**3**	0	2	0	**2**	3	1	0	**4**	1	1	0	**2**	**13**
Hungary	1	0	0	**1**	0	0	0	**0**	0	0	0	**0**	0	3	3	**6**	1	3	2	**7**	**14**
Mexico	0	2	0	**2**	0	1	0	**1**	0	0	0	**0**	2	1	2	**5**	1	1	0	**2**	**10**
Poland	0	0	0	**0**	0	1	0	**1**	0	0	0	**0**	1	3	2	**6**	1	1	2	**4**	**11**
Romania	0	0	2	**2**	0	1	0	**1**	0	0	0	**0**	1	3	1	**5**	0	0	2	**2**	**10**
Russia	0	1	0	**1**	0	3	0	**3**	3	3	3	**10**	0	2	0	**2**	2	0	0	**2**	**18**
S. Africa	0	0	0	**0**	0	2	0	**2**	1	1	0	**2**	3	2	2	**7**	2	0	0	**2**	**13**
Turkey	0	2	0	**2**	0	1	0	**1**	0	1	1	**2**	3	3	2	**9**	0	0	0	**0**	**14**
ASIA				**5.6**				**5.1**				**1.0**				**1.1**				**2.1**	**14.4**
OTHER EM				**1.3**				**2.0**				**2.7**				**5.0**				**2.7**	**13.7**

Note: Private credit is the latest loans and debt securities outstanding of private non-financial corporations and households; Private credit gap and real property price gap are the % deviation of the most recent 2015 data from its long-run average calculated recursively using a HP filter (lambda 400,000). Exports to China are for 2014 and include re-exports via Hong Kong; Non-food commodity exports comprise of metals, crude materials, coal, gas, petroleum and petroleum products exports in 2014; Correlations are based on daily data over 2005-2015 of the main stock market and spot USD exchange rate with the Shanghai Composite Index and the RMB respectively. Real GDP growth, CPI inflation and current account are Nomura's forecasts for 2015; Real GDP deviation is the percentage point deviation of 2015 growth from its 2011-2015 average. External debt are the latest available in 2015 and include estimates of non-financial corporate debt raised offshore by the subsidiary of a parent company; Hong Kong and Singapore are excluded because it is largely trade finance related. Import cover is the latest FX reserves divided by 12-month average goods imports. Fiscal data are IMF estimates for 2015. Policy rates are latest available; for Hong Kong and Singapore we use the 3month HIBOR and SIBOR rate. Vulnerability scores are calculated as follows: For each indicator, countries are assigned scores of 1, 2 or 3 if that country's indicator breaches certain thresholds; 0 otherwise. The higher the score, the more vulnerable a country is. Scores are determined as follows: Private credit 100-130%=1, 130-150%=2, >150% =3; Credit gap and property price gap of 5-10%=1, >10%=2; Exports to China of 3-6%=1, 6-10%=2, >10%=3; Non-food commodity exports of 15-30%=1, 30-50%=2, >50%=3; equity and FX correlation of 0.2-0.4=1, 0.4-0.5=2, >0.5=3; Real GDP growth of 1-2%=1, 0-1%=2, <0%=3; GDP growth deviation from 5y average of -0.5 to-1.0pp=1, of -1 to -2pp=2, <-2pp=3; CPI inflation of 5-10%=1, 10-15%=2, >15%=3; Current account of 0 to -2%=1, -2 to -4%=2, <-4%=3; external debt of 30-40%=1, of 40-50%=2, >50%=3; Import cover of 6-7=1, 5-6=2, <5=3; Fiscal balance of-2 to -4%=1, -4 to -6%=2, <-6%=3; Public debt of 50-60%=1, 60-70%=2, >70%=3; Policy rate of 2-3%=1, 1-2%=2, <1%=3. The SCORE for each risk category is the sum of the individual indicator scores, with the following additional conditions: For financial imbalances, if the score for both private credit gap and real property price gap=2, the joint score will be 7; For china exposure if the score for both exports to China and equity & FX correlation with China=3, an additional point is added to the joint score; For idiosyncratic factors if the score for real GDP growth>0 and the score for deviation of real GDP growth from 5y average=3, an additional point is added to the joint score; For balance of payments resilience if both the scores for current account and external debt=3 and the score for import cover>1, an additional point is added to the joint score; For room for policy response if the scores for both public debt and policy rate >1, an additional point is added to the joint score .Source: BIS, IMF, National sources, UN Comtrade, Haver, CEIC and Nomura Global Economics.

At some point, Asia's outsized financial cycle will reverse – be it gradually or abruptly. The latter should not be dismissed lightly given the liquidity illusion and feedback loops. The AUM of asset management companies has grown considerably to over USD75trn; they have similar investment benchmarks in Asia and the sector is very concentrated, with the top 20 managers accounting for 40% of total assets. If they reassess the risk-return trade-off on their investments in Asia, at a time when global banks are warehousing much less risk that before, what appears sufficient market liquidity now could quickly vanish, exaggerating the widening of credit spreads. This could set off a vicious feedback loop: corporate defaults, asset price declines, capital outflows and foreign currency mismatches, banks tightening credit standards and a downgrading of Asia's growth outlook – and all this leads to more defaults, restarting the loop. It is from this vantage point that, when we assess the economic outlook for both growth and fundamentals, our league table for Asia now has laggards outnumbering leaders, 6 to 2 (see *Box 2: Nomura's Asia league table*).

Box 2: Nomura's Asia league table

Leaders (strong growth outlook; sound fundamentals or moving in that direction)

India: We expect growth to rise to 7.8% in 2016, the fastest in Asia; cheap oil has led to a major improvement in the balance of payments; prudent monetary policy is taming inflation; Prime Minister Modi's leadership is ushering steady progress on reforms; huge untapped growth potential and the only large EM economy with a positive outlook.

The Philippines: Solid growth and record-low inflation; benefits from cheap oil; healthy balance of payments; strong fiscal finances; low leverage; lots of growth potential, including favourable demographics and the lowest investment to GDP ratio in Asia – we see an investment boom unfolding.

Laggards (weak or deteriorating growth outlook; poor fundamentals)

China: Powerful structural headwinds are simultaneously bearing down on the economy: overcapacity, debt overhang, a falling return on capital and a shrinking workforce. Macro policies have lost some effectiveness. Market-opening reforms are needed, but can hurt growth in the short run. Our base case is growth slowing to 5.8% in 2016 and gradual rebalancing, but the risk is a hard landing.

Hong Kong: Debt and property market bubbles and stuck between a rock (prospective Fed rate hikes) and a hard place (slowing China).

Korea: A massive current account surplus but mainly due to weak imports – is symptomatic of Korea's structural problems, including having the world's most rapidly ageing population; non-regular workers making up half the workforce; high household debt; overprotected SMEs and service sectors; and is vulnerable to a slowing China and a weak yen. We see a non-trivial risk of a debt-deflation trap and zero rates, Japan-style.

Singapore: Striving, so far unsuccessfully, to raise productivity amid high costs; high debt; high income inequality and an ageing population. Potential growth is slowing further, exacerbated by cyclical factors given rising short-term market rates, high exposure to China, oil rig-building and finance activity.

Taiwan: A large current account surplus but due to weak imports; debt is high; the working-age population will start to shrink in 2016; the economy has been isolated from free trade agreements; China exposure is very high and political uncertainty is on the rise with a presidential election in 2016.

Thailand: Weak growth and deflation; benefits from cheap oil are being more than countered by political uncertainty, high household debt and severe drought; an ageing population and lack of supply-side reforms. We expect the Bank of Thailand to become more overburdened.

In the middle

Indonesia: We have turned positive on growth, forecasting a rise to 5.2% in 2016 and 5.6% in 2017. Inflation is set to fall sharply, paving the way for policy rate cuts. Fiscal stimulus is gaining traction via infrastructure spending, and there is room for more. After a slow start, the government has shifted to a new root-and-branch, targeted approach to reforms with promising signs. The balance of payments, however, remains fragile.

Malaysia: For Asia's largest net commodity exporter, growth is holding up fairly well (we forecast 4% in 2016), the current account has sustained a sizable surplus and there has been major progress on fiscal consolidation. Political uncertainty may abate but external risks remain due to high foreign bond ownership, a limited FX reserve buffer and high exposure to China.

Inflation to rise – but cost-push, not demand-pull

In most countries – Indonesia being a notable exception – we expect CPI inflation to rise modestly in 2016, with Asia ex-Japan inflation rising to 2.9% from 2.4% in 2015. However, the rise is from a low level and, critically, it is driven mostly by base effects and cost-push, not demand-pull, factors. For commodities, our assumption that the oil price remains roughly around current levels through 2016 implies that, mathematically, the year-on-year rate of change in the oil price will no longer be a major disinflationary force. On the other hand, the current El Niño, which meteorological experts believe is the strongest since at least 1997-98 and will continue through Q1 2016, could lead to a surge in food prices – and the weighting of food in Asia's CPI basket is, on average, nearly 3x larger than energy-related items. Second, barring HKD and CNY, which have been heavily managed against USD, Asia's currencies have depreciated this year on a nominal effective basis. We expect more depreciation in 2016, which will be another inflationary force through higher import costs. Third, there will be some one-off fiscal inflationary pulses, such as the big cigarette tax hike in Malaysia and the 7th Pay Commission measures in India. In contrast, our weak growth outlook suggests that demand-driven inflation should remain dormant – indeed, capacity is significantly underutilised in most countries. Shortages in prime-age labour amid weak productivity growth could accelerate unit labour costs in some countries, such as Korea and Singapore, but we would expect companies to absorb these costs rather than lose market share.

Policy responses – time for more expansionary fiscal policies

We expect most Asian central banks to tolerate a moderate rise in inflation as it is starting from a low level and is not demand-driven. Furthermore, with weak growth and downside external risks, they are probably more amenable to a decline in real policy rates through higher inflation than further cuts to nominal rates, given: 1) policy rates in many countries are not far away from the lower bound; 2) the region already has large financial imbalances; and 3) the sensitivity of provoking capital flight amid a Fed hiking cycle. That said, we still expect more rate cuts and, unlike in past Fed hiking cycles, a decoupling. After a likely December Fed lift-off, we expect dovish Fed forward guidance to open a window for a final flurry of rate cuts through to end-March 2016 by the central banks of Australia (25bp), Indonesia (2x25bp), Korea (25bp), Taiwan (12.5bp) and Thailand (25bp). After March, we have pencilled in only four more interest rate cuts over the rest of the year: China (25bp in Q2 and Q3; 50bp bank RRR cuts in each quarter), Korea (25bp in June) and Thailand (25bp in Q2). The only Asian country that we expect to follow the Fed in 2016 is the Philippines, with 50bp of hikes.

In addition, we detect an increasing tolerance by Asian policymakers – Malaysia being a prime example in 2015 – to let their currencies adjust and act as shock absorbers to external shocks. We expect this to continue in 2016, with a whole bloc of Asian currencies depreciating against USD (including RMB to 6.80 by end-2016), thereby adding a further easing dimension to Asia's monetary conditions (see Asia FX: Harvesting the rough seas).

However, it is on the fiscal side where we see the greatest scope for easing in 2016. Monetary policy is becoming overburdened and, at 35% of GDP, Asia ex-Japan's average public debt in 2015 is low compared to the 105% ratio of advanced economies. We expect fiscal policy to be noticeably more stimulatory in 2016 than in 2015 in Hong Kong, Indonesia, the Philippines and Taiwan; and mildly more stimulatory in China, India and Korea. That said, demand-management policies can only do so much to support growth against structural headwinds. With weak productivity and labour no longer contributing as much to growth in at least half the region, the focus urgently needs to shift to supply-side reforms – but here we are not optimistic. The simple truth is that deregulation and market-opening reforms often involve short-term adjustment costs, and that is something politicians have little appetite for when growth is weak.

In sum, we see 2016 as an even more challenging year for Asia than 2015. A continued trend slowdown in growth, the region's outsized, late-stage financial cycle, its disproportionately high exposure to China and the potential for external shocks – from the Fed to geopolitics and oil prices – leave a larger confidence band than normal around our GDP forecasts, with the risks skewed firmly to the downside. At times like this, it pays to consider left-field events; we have considered four (see *Box 3: Thinking outside the box*).

Box 3: Thinking outside the box

While not our base case, here are four left-field events that we would not rule out:

China – a major flight to sovereign bonds? At some point, banks and investors must start differentiating credit risks, which will lead to increased corporate defaults – a necessary outcome to stamp out the chronic moral hazard problem. A repricing of credit risks could result in major investor flight from high-yield to high-grade bonds. Granted, the crackdown on local government financing vehicles and shadow banking is resulting in a substantial increase in government bond supply, but with the government meddling in the equity market and considering the relaxation of controls on foreign investor access to the local bond market, we expect demand for China sovereign bonds to far outstrip supply. We expect a dramatic deepening of China's government bond market and would not rule out the 10-year yield falling sharply to 1.75% by end-2016.

China – innovatively using bank reserves? China needs to deleverage, but it could cause banks to become too risk averse, restricting loans to even creditworthy borrowers. To address this risk, the ministry of finance (MOF) could consider a pre-emptive financial bailout by mobilising the 17.5% of underutilised bank reserves – equivalent to 35% of GDP – that are required to be kept at the PBoC earning just 1.6% interest. One option would be for the PBoC to slash the bank reserve requirement ratio, say by 500bp, and instruct the banks to use the freed-up reserves to buy higher-yielding government bonds. The MOF then uses the proceeds to carve out bad debt from the banks.

Korea's debt-deflation trap? Korea today has many similarities to the Japan of the 1990s. Its large conglomerates have aggressively moved factories overseas, limiting business and hollowing out the supplier role of the SME sector, which employs about 90% of the workforce. Its low unemployment rate masks the fact that half of the workforce is either part-time or self-employed, earning low wages. Weak household income growth has contributed to the surge in household debt to over 1.6x disposable income. Most importantly, it has the world's fastest-ageing population: in 2017, its working-age population will start to fall – and at a much faster rate than that of Japan – resulting in a rising propensity to save, rather than spend. The large current account surplus is symptomatic of this excess saving. Chronic weak domestic demand could lead to deflation. Fiscal resources need to be saved given the large contingent liabilities related to ageing and North Korea. Against this backdrop, we cannot rule out the policy rate being cut to zero in the next few years.

HKD re-pegged to the RMB? The HKD peg to USD could face its most trying time since it was adopted 32 years ago. Hong Kong imported US QE due to the peg, which has fuelled what seems to be a bigger property market bubble than in 1997, while its economy and markets have rapidly become more integrated with China's. Hong Kong would be stuck between a rock and a hard place if the Fed starts hiking and China's growth keeps slowing. Also, if Hong Kong were to face capital flight, the currency board system means that short-term interest rates would automatically rise, increasing the risk of a property market crash. Ideally, it is too early to re-peg to the RMB as it is not yet a fully convertible currency, nor have China's financial markets developed to the point where interest rates are the primary tool of monetary policy. However, China is making progress on both these fronts and re-pegging would be a shot in the arm for RMB internationalisation. An out-of-the-blue Swiss-franc style regime change is not out of the question.

China: Challenging times ahead

We expect reported real GDP growth to slow to 5.8% in 2016 on structural headwinds and a normalisation of financial sector growth.

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Overview

We expect reported real GDP growth to slow to 5.8% in 2016 and to 5.6% in 2017 from our estimate of 6.8% in 2015 (Figure 6). The primary drags are the continued property market correction and a normalisation of financial sector growth. Nominal GDP growth may remain lower than real GDP growth (i.e., the economy will stay in deflation for another year; Figure 7), which makes deleveraging more challenging.

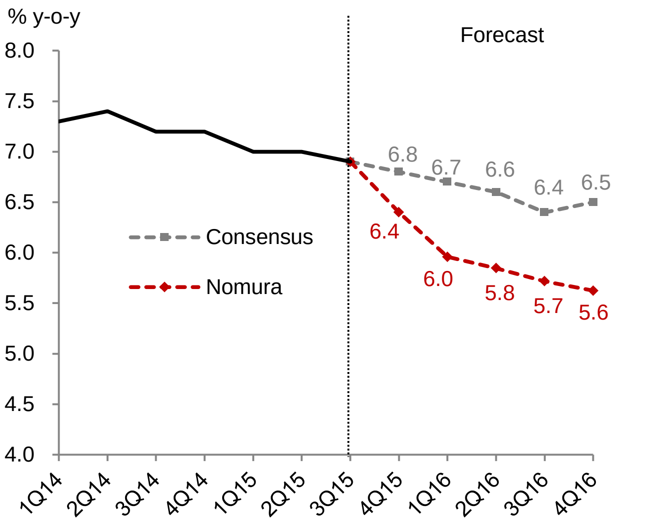
Our growth forecast has factored in a moderate overall fiscal stimulus and continued monetary easing, with the budget deficit climbing to 3.0% of GDP and the People's Bank of China (PBoC) cutting the bank reserve requirement ratio (RRR) four times (by 50bp each) and interest rates twice (by 25bp each) in 2016.

The government seems reluctant to launch a strong fiscal stimulus program, as it could disrupt the ongoing economic transition toward consumption, services and private enterprises. Also, the sharp contraction of land financing and associated local government financing vehicle (LGFV) borrowing will reduce the activeness of local government spending. The effectiveness of monetary easing is also declining due to high leverage and overcapacity in the economy.

The silver lining is that growth should become more balanced as economic structure improves further, in the sense that the share of consumption and services in GDP will pick up.

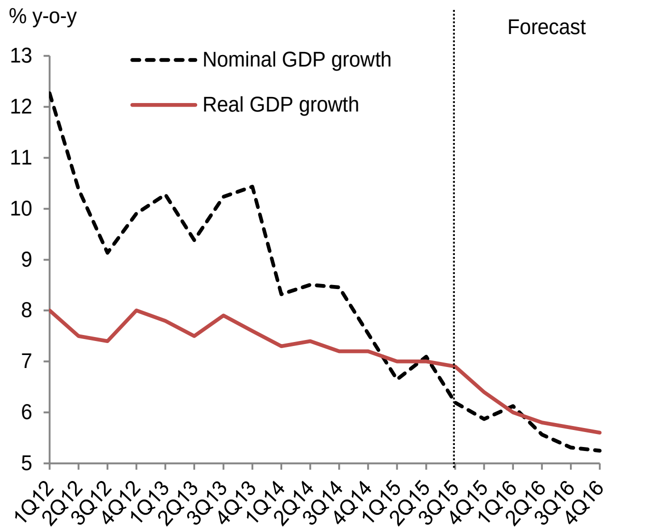
Our forecasts for the next two years are below consensus (Consensus: 6.5% in 2016 and 6.3% 2017). The main difference between our view and the consensus view lies in the assumptions made with regard to the extent of the property market correction and the size of the financial sector's contribution to growth. We believe property investment growth will drop further into negative territory over the next two years due to oversupply in lower-tier cities, continuing the negative spillovers on upstream heavy industries, while consensus expects stable, if not rebounding, property investment growth. In terms of the financial sector, we believe its contribution to GDP growth will normalise or even decline to below average in 2016 from its recent extraordinary high in H1 2015, given the hit to sentiment after the various equity market corrections, while consensus appears to expect a still-high contribution from this sector.

Fig. 6: Consensus *vs* Nomura forecasts



Source: Bloomberg and Nomura Global Economics estimates.

Fig. 7: Nominal *vs* real GDP growth



Source: CEIC and Nomura Global Economics.

Destocking in real estate is the main drag on growth

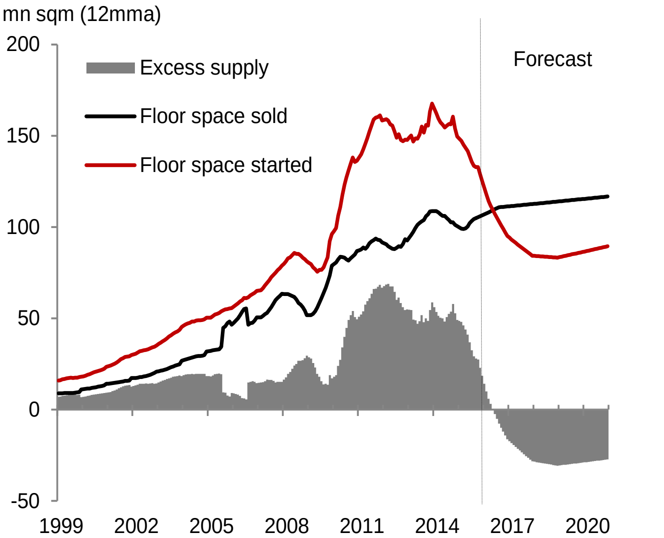
We expect fixed asset investment growth (FAI, nominal term) to slow further to 7.6% in 2016, from an estimated 10.1% in 2015 (2014: 15.7%), given the property market correction and the overcapacity problem. This, we estimate, will likely drive real GDP growth down by about 0.7pp.[1]

We believe the fundamental build-up of oversupply in the property sector underpins the current multi-year correction, which will be necessary to reduce new supply coming on the market and allow time to work through the existing inventory (Figure 8). Floor space under construction of residential housing was 4.9bn sqm as of October 2015, which should be sufficient to accommodate a rise in the urbanisation ratio of about 5pp by 2020 (or nearly 70 million people) and maintain urban floor space per capita at above 30 sqm. The correction may vary across cities, but many third- and fourth-tier cities, which account for nearly 70% of floor space under construction, may have to experience a prolonged correction given the severity of the problem. Overall, we expect nominal property investment growth to decline to -5.0% in 2016 from an estimated 1.5% in 2015 (2014: 10.5%).

We believe the plunge in land sales revenue and local government debt constraints will weigh on infrastructure investment growth, while the central government may step up and spend more with support from policy banks. Due to weakened property investment, land sales revenues – which account for about 25% of total local government revenues in 2014 – fell by 32% y-o-y in the first ten months of 2015, as opposed to Beijing's forecast of an only mild decline of 4.7% listed in the budget report to the National People's Congress in March (Figure 9). Moreover, the local government direct debt is capped at RMB16trn for this year and will likely be constrained by the warning line of a "100% debt-to-fiscal revenue ratio". These constrain local governments' spending on infrastructure projects. On the other hand, we believe the central government will likely increase its spending to boost nominal infrastructure investment growth, with support from policy banks. In sum, we forecast a modest rise in infrastructure investment spending growth to 21.0% in 2016 from an estimated 18.2% in 2015 (2014: 19.9%) – only partly offsetting the slowdown in property investment.

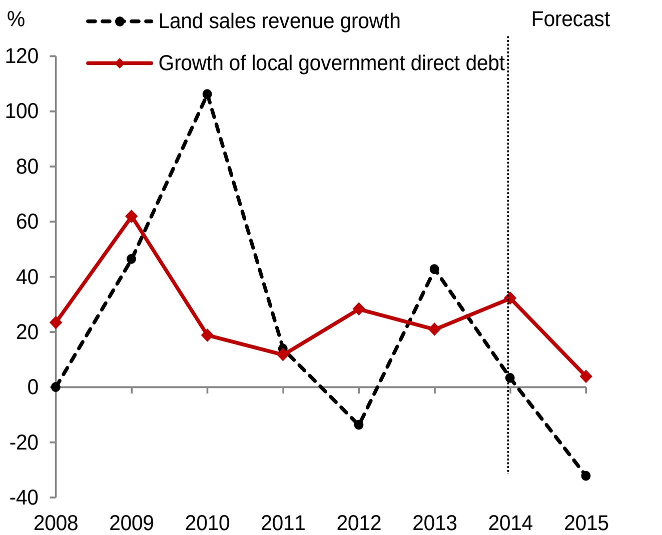
Manufacturing investment (nominal) will also likely struggle along with negative property investment growth, as many parts of the former (i.e., some upstream industries like steel, cement and flat glasses) heavily depend on the latter.[2] We expect it to soften to 4.5% in 2016 from an estimated 8.0% in 2015 (2014: 13.5%).

Fig. 8: Floor space started vs sold (flow)



Note: Excess supply is measured as the difference between floor space started and sold. The 12-month moving average data is presented here. For the stock of excess supply, we need to accumulate the flow data here. Source: CEIC and Nomura Global Economics.

Fig. 9: Land sales revenue and Local government direct debt



Note: Local government direct debt growth rate for 2015 is estimated based on official cap of RMB16trn. The year-on-year growth of land sales revenue over January-October is used for 2015. Source: CEIC and Nomura Global Economics.

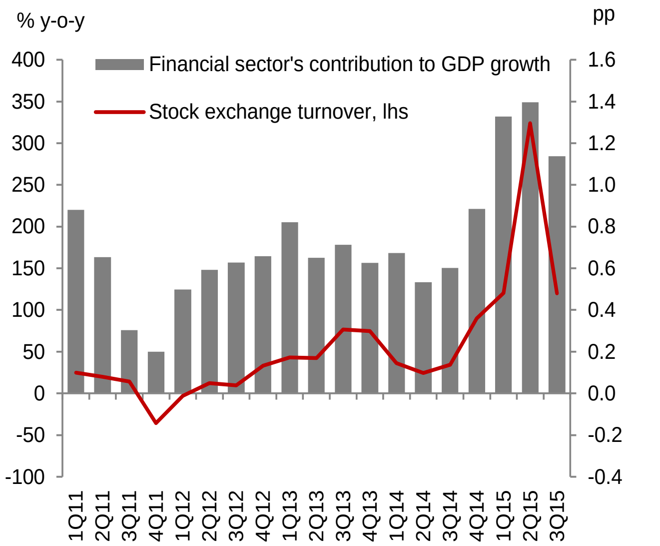
[1] China does not publish real growth data of gross capital formation (GCF). We estimate it will grow by 6.5% in 2015 and 5.1% in 2016, contributing 3.0pp and 2.3pp to GDP growth, respectively.

[2] By sector, FAI mainly comprises manufacturing (about 33.3% of total FAI), property and construction (25.5%), infrastructure (22.3%), service (13.7%), mining (2.9%), and agriculture (2.4%) investments in 2014.

Financial sector growth should normalise

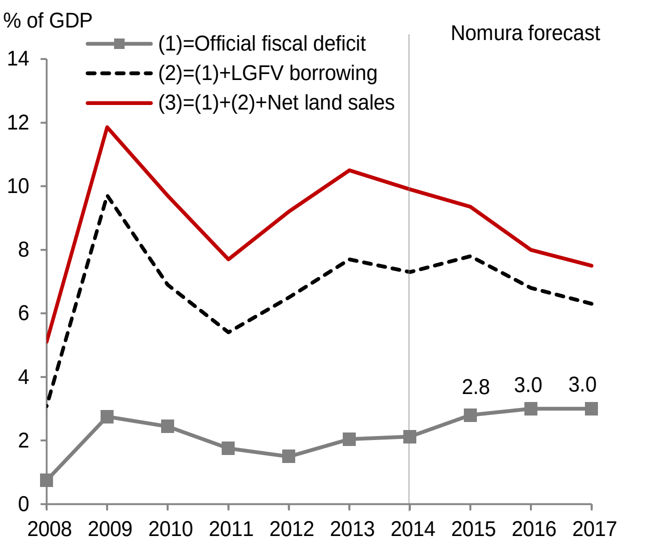
We estimate that the financial sector's contribution to GDP growth was abnormally high in H1 2015, contributing 1.4pp to the 7% growth of real GDP, compared with 0.6-0.7pp in previous years (Figure 10). Such a high contribution was mainly driven by the equity market bubble. There is a high correlation between stock exchange turnover and financial services value-added. Investor sentiment has taken some heavy blows in China as a result of the equity market sell-off and recent capital outflows, which we expect, will, over time, return market turnover to more normal levels. Normalisation of the financial sector's contribution should therefore cut 0.7-0.8pp from GDP growth, particularly in H1 2016 due to the high base this year.

Fig. 10: Exchange turnover and financial sector contribution



Note: Stock exchange turnover is the total trading value in both Shanghai and Shenzhen stock exchanges. Source: CEIC and Nomura Global Economics.

Fig. 11: IMF-defined augmented fiscal deficits



Note: Negative means fiscal surplus. Here the line (3) is the IMF-defined augmented fiscal deficit; historical data is from the IMF. Net land sales revenue is calculated as "land sales revenue minus land acquisition cost". Source: IMF, CEIC and Nomura Global Economics.

Fiscal and monetary policy will likely ease modestly

We expect the government to raise the official budget deficit to 3% of GDP in 2016 from this year's budgeted 2.3%, but we believe the overall fiscal stimulus will only be moderate given diminished local government borrowing via financing vehicles and declining land sales revenue. China's overall fiscal stance is determined by four major components: 1) the official fiscal budget; 2) local government borrowing via LGFVs; 3) land sales revenues; and 4) quasi-fiscal measures such as policy bank financing. The IMF estimates that China's augmented fiscal deficits (including the first three components) have been maintained at high levels for years, at around 10% of GDP (Figure 11).

Future land sales revenues and local government direct debt will be difficult to raise further, as explained above. As a result, the IMF-defined augmented fiscal deficit will also be hard to expand further – in fact, we estimate it will fall to 8% of GDP in 2016 from an estimated 9.4% in 2015. Incorporating strong supportive quasi-fiscal measures such as policy bank financing, we estimate that the broadest measure of the fiscal stance will be mildly expansionary (see Box 4: A comprehensive picture of fiscal policy in China).

We expect the PBoC to keep monetary policy accommodative during this challenging period. Expectations of subdued CPI inflation and continued PPI deflation will likely pressure the PBoC to ease its monetary stance further. In addition, the rising risk premium during the economic downturn will require monetary conditions to remain accommodative. We expect four 50bp RRR cuts and two 25bp benchmark interest rate cuts in 2016, and we also expect the PBoC to maintain growth of the monetary base via liquidity injections through pledged supplementary lending (PSL), medium-term lending facility (MLF) and other open market operations. It will also be necessary to maintain relatively accommodative monetary policy in 2017, in our view, so we have pencilled in another two 50bp RRR cuts. This policy easing may provide some buffer for economic growth via lower corporate financing costs, but it is unlikely to boost investment growth significantly, as its effectiveness has declined due to overcapacity and high leverage problems.

Box 4: A comprehensive picture of fiscal policy in China

China's overall fiscal stance in 2016 will be shaped largely by the following four components:

- *Official fiscal deficit*: As local governments are overloaded with large debts, the central government will likely take on the burden of a fiscal stimulus, increasing the budget deficit to 2.8% of GDP in 2015 and to at least 3% in 2016.
- *Local government borrowing via LGFVs*: The central government has finished its screening procedure for LGFV debt and identified RMB15.4trn of direct debt and RMB8.6trn of contingent debt for local governments in 2014. Local government direct debt is capped at RMB16trn for 2015, while contingent debt may continue to rise, but this should occur at a slower pace. Overall, this may contribute to local government financing by 3-4% of GDP in 2016.
- *Net land sales revenue*s: Along with our forecast of negative property investment growth next year, we expect land sales revenues to fall further by 20% in 2016, after the over 30% drop in 2015. Thus, net land sales revenues may contribute to local government financing by 1.0-1.5% of GDP in 2016 from an estimated 1.5% in 2015.
- *Quasi-fiscal measures (policy banks)*: As the financial arm of the central government, we believe policy banks (i.e., China Development Bank, the Agriculture Development Bank of China and the Export-Import Bank of China) will play a critical role in fiscal stimulus. After receiving capital injections, policy banks have started leveraging up by issuing special financial bonds to support infrastructure capex. We believe policy banks may contribute to government financing by 2.0%-2.5% of GDP in 2016 from an estimated 1.0% of GDP in 2015.

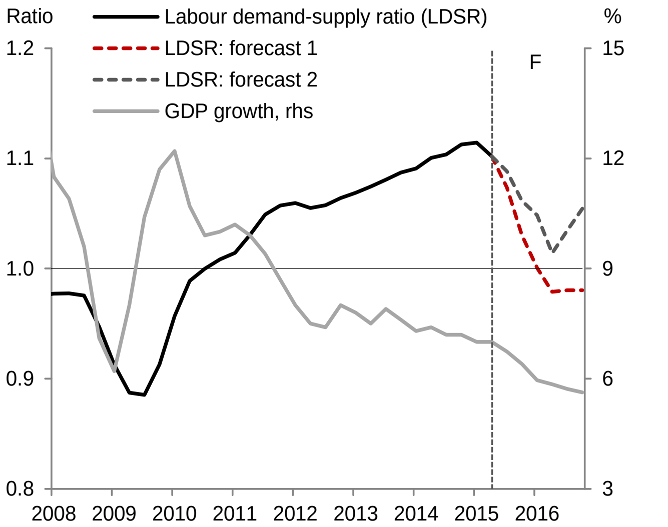
Based on the discussion above, with the contraction of land financing and the cap of local government debt, even a strong boost in the official fiscal budget is unlikely to result in a very expansionary overall fiscal policy. Alternatively, the government may try to find new funding through public-private partnerships (PPP). If the private party in a PPP is a state-owned enterprise (SOE), then there is little essential difference between that and an LGFV.

More risk exposure, but systemic risks likely to be contained

Slower growth may result in a modest rise in unemployment and rising financial risks, but not, in our base case, an economic hard landing, as we believe systemic risks remain manageable. Unemployment will likely rise over the next two years as GDP growth continues to slow and SOE reforms start to release hidden unemployment. However, with a shrinking labour force, we believe labour demand and supply should remain largely balanced. With our forecasted growth numbers, we estimate the labour demand-supply ratio should fall to slightly below 1.0 if we assume labour supply remains stable, and to remain above 1.0 if, in the less likely outcome, we assume labour supply follows its historical trend (Figure 12).

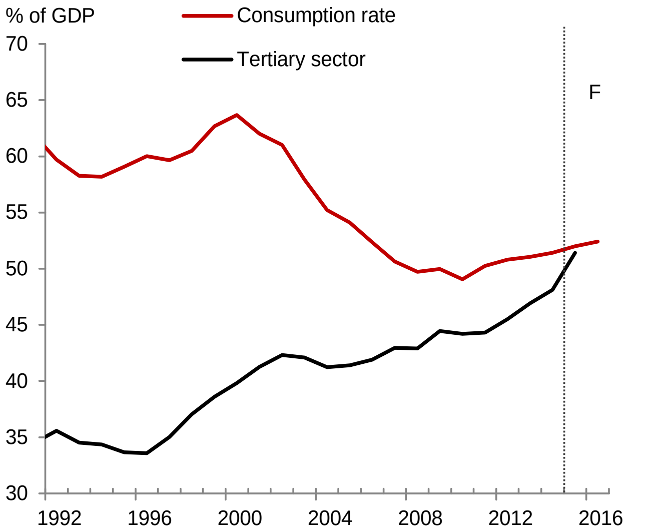
Financial risks are likely to increase as more corporate defaults occur, and as the bank non-performing loan ratio continues to rise. However, we see manageable systemic financial risks given that the government is a large stakeholder in the financial sector and as general government debt is still at a manageable level.

Fig. 12: Labour demand-supply ratio



Note: We forecast Labour demand-supply ratio (LDSR) by estimating labour supply and demand separately. Labour demand is estimated based on a regression against GDP growth rate and the interaction term of GDP growth rate and a logarithm of nominal GDP size. Labour supply is forecast in two ways: 1) assuming a flat supply from Q3 2015 and onwards (forming LDSR forecast 1), and 2) using an ARMA(1,1) process with quadratic time trend to simulate (forming LDSR forecast 2).
Source: CEIC and Nomura Global Economics.

Fig. 13: Consumption rate and tertiary sector output



Note: Consumption rate is measured as the share of final consumption in GDP.
Source: CEIC and Nomura Global Economics.

Silver lining: More balanced growth; economic structure to improve quickly

With the quick correction in the property sector, economic rebalancing is likely to be faster than initially expected. Gross capital formation's contribution to GDP growth may shrink quickly to 40%, while consumption growth should hold up well, ensuring its contribution to GDP growth continues to rise (Figure 13). This is clearly a "good" rebalancing – consumption-related service sectors and new technology industries remain robust, although, at this juncture, these improvements are nowhere near large enough to offset the sharp slowdown in property and some upstream industries (see Box 5: Monitoring services sector growth in China).

Moreover, as growth quickly converges to its long-run sustainable level (5-6% in the next decade; see *Asia Special Report - China: Slower is better*, 31 March 2015), we expect less painful adjustments in the economy from 2017. This should also enable the government to implement planned reforms more quickly, including those to SOEs, the government budget system, overcapacity in upstream industries (cuts), capital account opening, urbanisation (*hukou* policy) and demographics.

Box 5: Monitoring services sector growth in China

We believe it is quite critical for the market to watch the development of China's services sector to get a sense of overall growth momentum, given that the services sector accounts for half of GDP. As such, we gather 16 indicators to track service sector's growth, including three survey leading indicators and 13 sectorial indicators, covering financial, transportation, TMT (technology, media, and telecommunication), catering and tourism segments (Figure 14). With this pulse table, we try to grasp to what extent the growth of the services sector is accelerating. In October, we see that only 44% of these indicators exhibited any acceleration, unchanged from September but down from 50% in August.

Fig. 14: Economic pulse: service sector

	Unit	Q1-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Direction
Leading indicator											
Minxin non-manufacturing PMI	%	45.4	46.4	45.7	43.1	38.5	40.9	42.3	44.2	42.9	Down
Caixin service PMI	%	52.0	52.9	53.5	51.8	53.8	51.5	50.5	52.0	51.2	Down
Official service PMI	%	52.8	52.4	52.0	52.3	52.8	52.6	53.0	52.3	52.8	Up
Financial sector											
Aggregate financing stock	% y-o-y	12.8	12.2	11.9	11.5	11.9	11.9	11.9	11.7	n.a.	Down
Stock turnover	% y-o-y	224.1	761.1	1,032.9	981.4	427.6	237.2	59.2	144.6	89.3	Down
Bond turnover	% y-o-y	77.7	78.6	96.4	108.0	147.5	136.9	89.8	106.4	161.0	Up
Insurance premium revenue	% y-o-y	20.4	17.5	16.9	18.2	25.2	16.4	19.1	21.9	n.a.	Up
Transportation and postal											
Passenger traffic	% y-o-y	5.9	8.3	6.9	5.7	6.3	7.0	7.1	6.8	n.a.	Down
Postal services	% y-o-y	28.8	29.9	32.7	42.3	36.3	39.7	41.7	39.5	n.a.	Down
Logistics fees	% y-o-y ytd	0.0	3.2	n.a.	n.a.	5.5	4.8	4.2	3.8	n.a.	Down
Freight traffic	% y-o-y	1.3	-2.2	-0.5	-2.1	2.3	0.9	-1.5	-0.7	n.a.	Up
Technology, media and telecommunication											
Telecom business	% y-o-y	22.0	22.6	23.6	27.0	27.4	29.7	30.2	28.7	n.a.	Down
Advertisement fee	% y-o-y	11.5	6.0	-2.8	-1.3	-1.4	28.8	20.5	20.0	n.a.	Down
Software service revenue	% y-o-y	17.5	16.7	17.1	17.1	16.6	16.7	16.5	16.4	n.a.	Down
Catering											
Catering revenue	% y-o-y	11.3	11.7	11.7	11.6	12.2	12.4	12.1	12.4	n.a.	Up
Tourism											
Tourists to Northeast Asia	% y-o-y	12.8	7.4	11.9	-0.9	-9.8	-3.2	2.1	3.5	n.a.	Up
# of indicators data available		**16**	**16**	**15**	**15**	**16**	**16**	**16**	**16**	**5**	
% of indicators with improvement			**50%**	**60%**	**40%**	**56%**	**50%**	**44%**	**44%**		

Note: (1) "Direction" shows the latest change in each indicator. (2) *Caixin* service PMI is surveyed by Markit and sponsored by *Caixin* (formerly called HSBC service PMI), while *Minxin* non-manufacturing PMI is surveyed by China Academy of New Supply-side Economics and Minsheng Bank. (3) Unit of the underlying series: passenger traffic: person-km; freight traffic: ton-km; tourists to Northeast: person; the rest: RMB. Source: WIND, CEIC and Nomura Global Economics.

Risks to our forecast

On balance, we see upside risks to our reported 2016 GDP forecast (Figure 15). The key upside risk is a much-looser-than-expected fiscal policy. During the Fifth Plenum, President Xi mentioned that "from the perspective of the need to double GDP, the bottom line for annual average economic growth between 2016 and 2020 is more than 6.5%." He also said "it's possible for China's economy to maintain growth of around 7%." The December Central Economic Working Conference is likely to reflect this goal by setting the official 2016 GDP growth target at 6.5-7.0%.

Given the strong headwinds facing the economy, we believe the target will be difficult to reach without the government rolling out a large fiscal stimulus and reverting to the LGFV expansion, which could be under the heavily promoted umbrella of PPP schemes. If the "private" member of a PPP is in effect a government-backed entity then the PPP scheme would be undermined. However, while worth acknowledging as a risk, we believe the probability of this scenario materialising is low given the government's current reform-oriented stance and the risk it brings of a bigger economic setback further out.

Another risk lies in data collection. It is difficult to collect the fragmented data in the services sector, the size of which has long been underestimated in China. The National Bureau of Statistics (NBS) has been improving its data collection over the past few years. As China has adopted the IMF's Special Data Dissemination Standard (SDDS), the NBS will likely make greater efforts to improve data coverage and data collection, which may increase the risk of overestimating the growth of those sectors. Indeed, overall services sector output grew by 8.6% y-o-y in Q3 2015, largely unchanged from Q2, but the growth of its "other" component jumped to 9.5% y-o-y from 8.7% in Q2, its highest since Q3 2011, which clearly contradicts the overall trend of the whole economy.

Fig. 15: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016	2017
Real GDP	**7.0**	**7.0**	**6.9**	6.4	6.0	5.8	5.7	5.6	**7.3**	6.8	5.8	5.6
Contributions to GDP (pp):												
Final consumption									**3.8**	3.7	3.2	3.2
Gross capital formation									**3.4**	3.0	2.3	2.2
Net exports (goods & services)									**0.1**	0.1	0.3	0.2
CPI	**1.2**	**1.4**	**1.7**	1.4	2.1	1.9	1.8	1.7	**2.0**	1.4	1.9	2.0
PPI	**-4.6**	**-4.7**	**-5.7**	-5.9	-4.0	-4.2	-3.9	-4.0	**-1.9**	-5.2	-4.0	-1.5
Retail sales (nominal)	**10.6**	**10.2**	**10.7**	10.9	10.0	9.3	9.2	9.2	**12.0**	10.6	9.4	9.3
Fixed-asset investment (nominal, ytd)	**13.5**	**11.4**	**10.3**	10.1	8.9	8.4	7.9	7.6	**15.7**	10.1	7.6	7.3
Industrial production (real)	**6.4**	**6.3**	**5.8**	5.6	5.5	5.3	5.2	4.7	**8.3**	6.0	5.2	4.6
Exports (value)	**4.5**	**-2.8**	**-6.1**	-6.0	1.5	3.0	3.5	2.0	**6.0**	-3.0	2.5	3.7
Imports (value)	**-17.8**	**-13.8**	**-14.4**	-16.3	0.3	-3.6	-5.8	-5.0	**0.5**	-15.5	-3.6	2.0
Trade surplus (US$bn)	**123.8**	**137.5**	**162.8**	192.2	130.3	169.2	208.8	225.1	**382.7**	616.3	733.4	787.7
Current account (% of GDP)	**3.2**	**2.7**	**2.3**	1.8	3.0	3.2	3.5	3.2	**2.1**	2.5	3.2	3.0
Fiscal balance (% of GDP)									**-2.1**	-2.8	-3.0	-3.0
New RMB loans (CNY trn)	**3.7**	**2.9**	**3.3**	1.8	3.5	3.1	2.2	2.4	**9.8**	11.6	11.2	11.5
Aggregate financing (CNY trn)	**4.6**	**4.1**	**3.1**	2.6	4.3	3.9	2.8	3.0	**16.5**	14.5	14.1	14.7
Money supply M2 growth	**11.6**	**11.8**	**13.1**	12.8	12.5	11.6	10.8	10.6	**12.2**	12.8	10.6	10.3
1-yr bank lending rate (%)	**5.35**	**4.85**	**4.60**	4.35	4.35	4.10	3.85	3.85	**5.60**	4.35	3.85	3.85
1-yr bank deposit rate (%)	**2.50**	**2.00**	**1.75**	1.50	1.50	1.25	1.00	1.00	**2.75**	1.50	1.00	1.00
Reserve requirement ratio (%)	**19.5**	**18.5**	**18.0**	17.5	17.0	16.5	16.0	15.5	**20.0**	17.5	15.5	14.5
Exchange rate (CNY/USD)	**6.20**	**6.20**	**6.36**	6.45	6.54	6.64	6.72	6.80	**6.21**	6.45	6.80	6.79

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. The CNY/USD forecast is for the spot rate. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015.
Source: CEIC and Nomura Global Economics.

Taiwan: Looming fiscal stimulus

We expect the central bank to deliver another 12.5bp rate cut in December 2015 and the new government to implement fiscal stimulus in 2016.

Activity: We expect real GDP growth to rebound to 2.4% in 2016 from 1.2% in 2015, supported by further monetary easing and a sizable fiscal stimulus. GDP declined in Q3 2015 for the first time since Q4 2009, mainly owing to weaker exports. Although exports may be showing signs of having bottomed, we expect only a gradual improvement due to weak external demand, notably from China. The growing number of free trade agreements between other countries in the region is also likely disadvantaging Taiwan. Moreover, the inventory/shipment ratio has continued to rise, largely because of a build-up in inventory in the high-tech and base-metal sectors, which will likely be a drag on the economy through 2016. On 30 October 2015, the government announced a TWD4.1bn (0.03% of GDP) stimulus package to boost consumption, including subsidies for the purchase of mobile phones and domestic travel. From 7 November 2015 to 29 February 2016, all designated purchases and domestic tours are eligible for government subsidies. However, the impact on the economy is likely to be limited, in our view, given the small scale of the stimulus. We expect weaker growth momentum to require further rate cuts and fiscal stimulus.

Inflation and monetary policy: We expect CPI inflation to rise by 0.7% y-o-y in 2016 after a 0.4% decline in 2015 due to the base effect from lower crude oil prices. CPI inflation is likely to stay at very low levels as low commodity and imported goods prices from China continue to exert downward pressure. We expect the Central Bank of China (CBC) to deliver another 12.5bp discount rate cut to 1.625% in December 2015 and then keep rates unchanged throughout 2016.

Fiscal policy: The Executive Yuan submitted the FY16 budget (fiscal deficit of 1.0% of GDP) in September 2015, but we expect more fiscal stimulus to be added regardless of who wins the presidential and legislative elections on 16 January 2016. As such, we expect the fiscal deficit to widen to 2.0% of GDP in 2016.

Risks: Stronger/weaker-than-expected demand from mainland China is a major upside/downside risk to Taiwan's growth outlook, given that mainland China and Hong Kong combined accounted for 27% of Taiwan's total exports in 2015. With the presidential and legislative elections in January 2016, any rise in political uncertainty could be another risk, potentially delaying business investment and reforms.

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Fig. 16: Details of the forecast

%y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016	2017
Real GDP (sa, % q-o-q)	**0.6**	**-1.1**	**-0.3**	2.0	1.8	-1.5	0.3	2.0				
Real GDP	**4.0**	**0.6**	**-0.6**	1.2	2.4	2.0	2.6	2.5	**3.9**	1.2	2.4	2.6
Private consumption	**3.7**	**3.6**	**0.5**	2.0	3.0	3.1	2.9	2.9	**3.3**	2.4	3.0	3.1
Government consumption	**-2.7**	**0.5**	**-0.4**	0.2	2.8	1.9	1.9	1.9	**3.6**	-0.5	2.1	1.9
Gross fixed capital formation	**-0.4**	**0.6**	**3.1**	3.5	3.0	3.0	2.8	2.7	**1.8**	1.7	2.9	3.0
Exports (goods & services)	**6.1**	**-0.7**	**-3.0**	0.1	2.5	2.8	3.0	3.2	**5.9**	0.5	2.9	3.2
Imports (goods & services)	**2.9**	**3.4**	**-2.2**	0.4	3.0	3.3	3.5	3.7	**5.7**	1.1	3.4	3.7
Contributions to GDP growth (% points)												
Domestic final sales	**1.5**	**2.3**	**0.9**	1.8	2.7	2.7	2.5	2.4	**2.7**	1.6	2.6	2.6
Inventories	**0.0**	**1.1**	**-0.8**	-0.5	-0.2	-0.5	0.2	0.1	**0.5**	0.0	-0.1	0.0
Net trade (goods & services)	**2.5**	**-2.8**	**-0.8**	-0.2	-0.1	-0.2	-0.1	0.0	**0.6**	-0.3	-0.1	-0.1
Exports	**-4.2**	**-9.8**	**-13.9**	-14.5	-7.6	-6.5	-3.1	-0.3	**2.7**	-10.7	-4.4	4.7
Imports	**-15.0**	**-14.9**	**-19.4**	-7.0	-3.6	-7.2	-1.2	-0.6	**1.5**	-14.2	-3.2	1.6
Merchandise trade balance (US$bn)	**13.4**	**12.3**	**12.8**	6.4	10.1	12.0	11.3	6.5	**39.7**	44.9	39.9	48.8
Current account balance (% of GDP)	**16.7**	**12.5**	**15.0**	6.4	9.7	11.7	10.9	6.9	**12.3**	12.6	10.4	11.2
Fiscal balance (% of GDP)									**-0.8**	-1.5	-2.0	-2.0
Consumer prices	**-0.6**	**-0.7**	**-0.3**	-0.2	0.5	0.7	0.8	0.6	**1.2**	-0.4	0.7	0.9
Unemployment rate (%)	**3.8**	**3.8**	**3.8**	3.8	3.9	4.0	4.2	4.0	**4.0**	3.8	4.0	4.1
Discount rate (%)	**1.875**	**1.875**	**1.750**	1.625	1.625	1.625	1.625	1.625	**1.875**	1.625	1.625	1.750
10-year T-bond (%)	**1.56**	**1.52**	**1.15**	1.18	1.22	1.25	1.30	1.35	**1.62**	1.18	1.35	1.45
Exchange rate (NTD/USD)	**31.3**	**30.9**	**33.0**	32.9	33.6	33.9	34.1	34.2	**31.7**	32.9	34.2	33.3

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015.
Source: CEIC and Nomura Global Economics.

Hong Kong: Tough year ahead

Growing external headwinds are likely to cause domestic demand to falter. We expect the property market correction to be orderly, but the danger is it is more abrupt.

Activity: GDP growth slowed to 2.3% y-o-y in Q3 2015, as solid private consumption could only partly offset weakness in investment and exports. We expect the economy to continue to lose growth momentum through 2016, given its vulnerability to weaker Chinese growth and higher US rates. Increasingly negative sentiment in property markets from expectations of a Fed lift-off should reduce property transaction volumes and lower house prices. This, combined with recent equity market corrections, will likely be a drag on private consumption. Inward tourism is expected to remain weak, especially from mainland tourists tightening their belts as growth in China slows and on a stronger HKD. International trade volume via Hong Kong ports should also remain sluggish. All in all, we expect GDP growth to slow to 2.3% in 2016 from 2.4% in 2015, but the risk is a sharper slowdown if there is a disorderly unwinding of Hong Kong's outsized financial cycle of excessive domestic credit and highly elevated property prices.

Policy: Since 2009, the Hong Kong Monetary Authority (HKMA) has introduced seven rounds of macroprudential measures and the government has implemented four demand-management measures such as a special stamp duty in an attempt to stabilise the housing market. Our baseline view is that house prices will decline moderately in 2016 as our US Economics team expects the Fed to deliver just three interest rate hikes until the end of 2016. That said, we do not expect policymakers to ease property market cooling policies unless there is a sharp market correction that could harm the banking system, fiscal balance and the economy. Meanwhile, we expect a stimulative FY16-17 budget to include one-off measures for households such as reducing salaries tax, increasing tax allowances and waiving government rates and rents.

Inflation: We expect CPI inflation to slow to 2.5% in 2016 from 3.0% in 2015. Hong Kong is a small, service-based and open economy, with most of its necessities imported. Therefore, lower oil prices and a stronger HKD (in trade-weighted terms) tend to aggravate deflationary pressures, causing import prices to fall sharply.

Risks: Hong Kong is the world's most exposed economy to a China hard economic landing. Also, its property market imbalance and high domestic leverage pose risks to financial stability, especially if the Fed hiking cycle turns out to be steeper than expected.

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Fig. 17: Details of the forecast

% y-o-y growth unless otherwise	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016	2017
Real GDP (sa, % q-o-q)	**0.7**	**0.4**	**0.9**	0.0	0.6	0.5	1.1	0.4				
Real GDP	**2.4**	**2.8**	**2.3**	2.1	2.0	2.1	2.3	2.6	**2.5**	2.4	2.3	2.9
Private consumption	**5.3**	**6.1**	**4.3**	3.0	2.8	2.9	3.0	3.4	**3.2**	4.6	3.0	3.5
Government consumption	**3.4**	**3.3**	**2.6**	3.5	3.3	3.3	3.6	3.4	**3.0**	3.2	3.4	3.5
Gross fixed capital formation	**7.5**	**5.2**	**-6.5**	4.0	2.4	3.1	4.5	3.1	**-0.2**	2.4	3.3	4.0
Exports (goods & services)	**0.3**	**-2.7**	**-2.8**	-0.4	-0.9	-1.4	-1.1	-0.8	**0.8**	-1.4	-1.1	0.8
Imports (goods & services)	**0.7**	**-2.5**	**-3.3**	0.3	-0.2	-0.8	-0.5	-0.2	**1.0**	-1.2	-0.4	1.4
Contributions to GDP (% points)												
Domestic final sales	**5.5**	**5.8**	**1.5**	3.3	2.8	3.2	3.2	3.4	**2.3**	4.0	3.1	3.7
Inventories	**-2.3**	**-2.7**	**-0.2**	0.5	0.7	0.3	0.5	0.5	**0.5**	-1.1	0.5	0.4
Net trade (goods & services)	**-0.8**	**-0.2**	**1.0**	-1.7	-1.5	-1.4	-1.4	-1.2	**-0.3**	-0.4	-1.4	-1.2
Unemployment rate (sa, %)	**3.3**	**3.2**	**3.3**	3.3	3.4	3.4	3.4	3.4	**3.3**	3.3	3.4	3.4
Consumer prices	**4.4**	**3.0**	**2.3**	2.4	2.0	2.5	2.5	3.0	**4.4**	3.0	2.5	3.0
Exports	**2.3**	**-1.9**	**-4.1**	1.0	0.9	1.0	1.6	2.1	**3.2**	-0.8	1.4	1.5
Imports	**1.5**	**-3.2**	**-6.7**	1.3	1.5	0.6	0.2	0.3	**4.0**	-1.9	0.6	2.3
Current account balance (% of GDP)	**-0.2**	**0.3**	9.2	2.7	-0.4	-2.3	11.1	4.9	**1.9**	3.1	2.7	2.3
Fiscal balance (% of GDP)									**3.6**	1.3	1.0	2.0
Discount rate (%)	**0.50**	**0.50**	**0.50**	0.75	0.88	1.00	1.13	1.25	**0.50**	0.75	1.25	2.00
3-month Hibor (%)	**0.39**	**0.39**	**0.40**	0.65	0.78	0.90	1.03	1.15	**0.38**	0.65	1.15	1.90
10-year government bond (%)	**1.43**	**1.76**	**1.53**	1.68	1.70	1.80	1.80	1.85	**1.85**	1.68	1.85	2.00
Exchange rate (HKD/USD)	**7.75**	**7.75**	**7.75**	7.75	7.77	7.80	7.81	7.82	**7.76**	7.75	7.82	7.81

Notes: Numbers in bold are actual values; others forecast. The 'inventories' component contribution to GDP also includes statistical discrepancy. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015. Source: CEIC and Nomura Global Economics.

Korea: Rate-cutting cycle is not over yet

We expect the Bank of Korea to cut policy rates by 25bp to 1.25% in February and further to 1.00% in June 2016.

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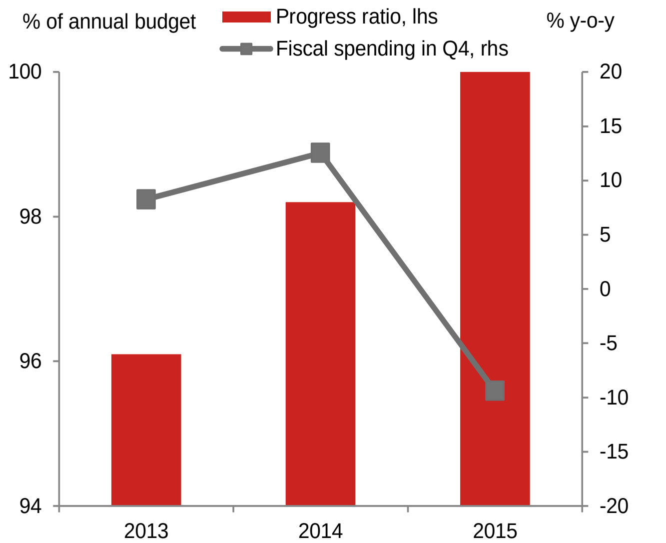
Activity: We expect real GDP growth to average 2.5% in 2015-16 before slightly rising to 2.7% in 2017 – below our estimate of the economy's growth potential of 3.2%. GDP growth accelerated to 1.3% (sa) q-o-q in Q3 from 0.3% in Q2. However, we doubt this momentum will continue into Q4 and beyond. Fiscal expenditure, supported by the FY15 extra budget, contributed 0.9 percentage points (pp) to Q3 GDP. Excluding this largely one-off fiscal impulse, private sector demand (private consumption, business investment, inventories and net exports) contributed only 0.4pp.

We expect GDP growth to slow markedly to 0.4% q-o-q in Q4 and remain low in 2016. Under our optimistic assumption that the government spends 100% of the FY15 budget, the remainder left for Q4 2015 implies that fiscal spending will *fall* by 9.4% y-o-y in Q4, subtracting 0.2pp q-o-q from Q4 GDP (Figure 18). Also, the FY16 budget suggests a smaller fiscal impulse and multiplier effect.

Weaker exports should depress GDP growth over the next couple of quarters. China's economic rebalancing – i.e., fixed asset investment's contribution to GDP growth falling while consumption growth holds up well – should have an adverse effect on commodity-producing emerging economies which, in turn, should have a negative impact on Korean exports, 58% of which were shipped to emerging economies this year.

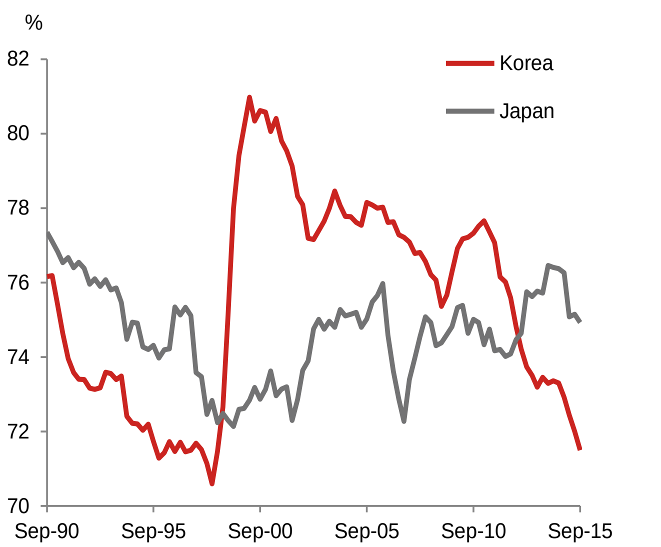
For domestic demand, we expect private consumption growth to underperform GDP growth as households' propensity to consume (i.e., consumption/disposable income) has fallen to 71.5% in Q3 2015 – close to its historical low of 70.6% in Q2 1998 and far below that of Japan, should fall further in 2016 (Figure 19). The household sector has a high level of precautionary savings as it appears to have a low sense of job security, lower incomes after retirement and the heavy burden of servicing household debt, which has risen to over 1.6x disposable income. A high inventory burden, a low manufacturing operating ratio and soon-to-tighten mortgage loan standards suggest that some highly indebted companies, the self-employed and households could face liquidity constraints. Construction investment should gain more strongly in 2015-16 than we had initially thought as construction orders and housing permits rose to a decade high in September 2015. However, this also suggests that construction investment should slow sharply in 2017 owing to oversupply in housing units.

Fig. 18: Korea's fiscal spending in Q4



Source: MOSF and Nomura Global Economics estimates.

Fig. 19: Propensity to consume: Korea and Japan



Source: CEIC and Nomura Global Economics.

Business investment has recovered strongly, driven by electronic and transportation equipment. However, the government is encouraging corporate restructuring, especially in the shipbuilding, shipping, steel and machinery sectors, which could tighten bank's credit standards on corporate loans and result in lower business investment in 2016.

Inflation: We expect the Bank of Korea (BOK) to lower the inflation target for the next three years, from 3.0% (mid-point basis) to 2.5%. Mainly because of a base effect in oil prices, headline CPI inflation will likely rise but very modestly and from a very low level, to 1.5% in 2016 from 0.7% in 2015, as we expect firms' margins to be squeezed by intensifying price competition. As a result, we expect headline and core CPI inflation to even fall short of the new lower inflation target (Figure 20).

Policy: Our forecasts suggest that Korea's GDP growth rate and CPI inflation will remain well below those of the global economy through 2017, as Korea's potential GDP growth remains on a downward trajectory. This is fundamentally because: 1) slower population growth, lower relative prices of capital goods and weak labour productivity growth should all constrain new investments; 2) we expect households (with a diminished sense of job security and income flows after retirement) and corporates (which respond cautiously to declines in domestic and global demand amid the structural rebalancing of China's economy) to increase their savings rates; and 3) financial regulatory changes (tougher regulatory capital standards and tighter regulation of derivatives require financial institutions to hold more government securities) to lower leverage in the financial system.

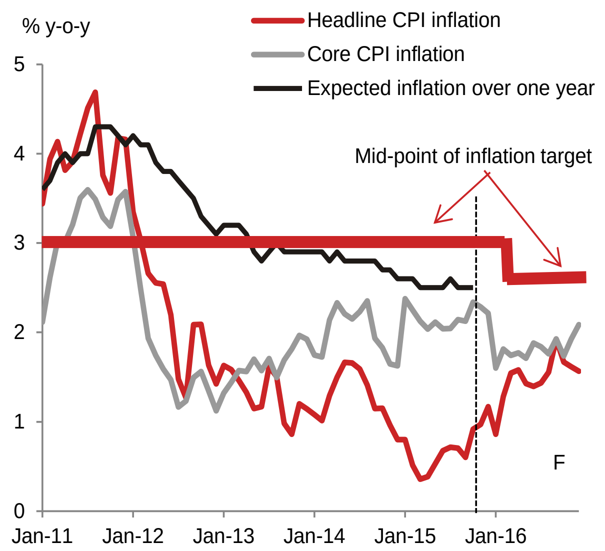
In our recent Special Report (see *The Bank of Korea is approaching uncharted territory*, 9 September 2015), we argue that the BOK's real policy rate is less accommodative in the context of a neutral real interest rate. Our views remain intact.

As of September 2015, Korea's real policy rate is higher than Nomura's Korea Trade-Weighted Real Policy Rate or NKTWRPR [*Bloomberg* ticker: NMEIKRPR] – the average of each trading partner country's real policy rates weighted by their respective market share for Korean exports. A higher NKTWRPR real policy rate differential is positively correlated with Korea's REER appreciation and negatively correlated with the GDP growth gap between Korea and world. That said, Korea's real policy rates are still negative for Korea's international competitiveness.

Government measures to limit household debt and encourage (unhedged) overseas portfolio investment will likely make room for the BOK to cut policy rates, which should enhance the exchange rate channel (i.e. KRW depreciation) to support growth and prevent deflation risks, while limiting the bank lending channel to avoid a household debt crisis (see Box 6: Forthcoming measures to encourage overseas portfolio investments).

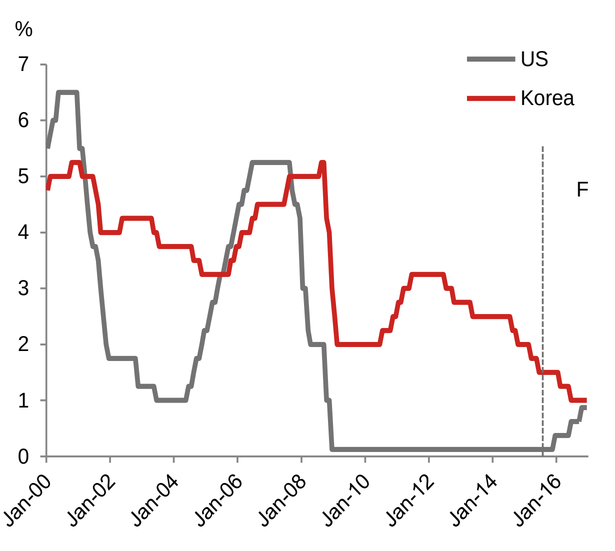
All in all, we expect the BOK to cut policy rates by 25bp to 1.25% in February and further to 1.00% in June 2016 (Figure 21). As of writing, this is an out-of-consensus call.

Fig. 20: Nomura's Korea inflation forecast



Source: CEIC and Nomura Global Economics estimates.

Fig. 21: Nomura's policy rate forecast: Korea and the US



Source: CEIC and Nomura Global Economics estimates.

Risks: We do see a risk of the BOK leaving rates unchanged through 2016 if: 1) exports grow unexpectedly; 2) USD/KRW surges owing to sudden, massive capital outflows in emerging economies; 3) if the Fed moves toward a steeper hiking cycle; or 4) the government's measures to limit household debt fail.

Fig. 22: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2014	2015	2016	2017
Real GDP (sa, % q-o-q, annualized)	**3.3**	**1.3**	**5.3**	1.4	2.6	2.0	2.4	2.0				
Real GDP (sa, % q-o-q)	**0.8**	**0.3**	**1.3**	0.4	0.7	0.5	0.6	0.5				
Real GDP	**2.5**	**2.2**	**2.7**	2.8	2.6	2.8	2.1	2.3	**3.3**	2.5	2.5	2.7
Private consumption	**1.5**	**1.7**	**2.1**	2.2	2.0	2.8	2.0	1.9	**1.8**	1.9	2.2	2.0
Government consumption	**3.1**	**3.3**	**3.0**	2.9	3.3	3.1	2.0	2.4	**2.8**	3.1	2.7	2.5
Construction investment	**0.6**	**1.6**	**5.7**	15.6	10.9	10.3	6.1	6.1	**1.0**	5.6	8.3	1.5
Business investment	**5.8**	**5.0**	**6.6**	3.0	1.8	2.3	1.5	2.0	**5.8**	5.1	1.9	1.5
R & D investment	**1.7**	**0.8**	**1.2**	2.0	0.7	2.4	4.4	6.1	**4.6**	1.3	3.4	5.3
Exports (goods & services)	**0.1**	**-0.8**	**0.3**	-0.5	-0.8	-1.3	-0.8	0.0	**2.8**	-0.2	-0.7	1.8
Imports (goods & services)	**1.9**	**1.9**	**1.9**	1.9	1.9	1.4	0.3	0.9	**2.1**	2.3	1.1	2.0
Contributions to GDP growth (% points)												
Domestic final sales	**2.4**	**2.2**	**3.5**	4.1	4.8	4.2	2.6	2.7	**2.8**	3.1	3.4	2.7
Inventories	**1.0**	**1.1**	**0.7**	0.2	-0.7	0.0	0.1	0.0	**0.0**	0.7	0.0	0.0
Net trade (goods & services)	**-0.9**	**-1.2**	**-1.4**	-1.5	-1.5	-1.4	-0.6	-0.4	**0.5**	-1.3	-1.0	0.0
Unemployment rate (sa, %)	**3.7**	**3.7**	**3.6**	3.6	3.5	3.5	3.5	3.5	**3.5**	3.6	3.5	3.5
Consumer prices	**0.6**	**0.5**	**0.7**	1.0	1.2	1.5	1.6	1.6	**1.3**	0.7	1.5	2.0
Current account balance (USDbn)	**23.5**	**28.9**	**28.3**	39.4	24.1	36.8	24.8	34.3	**89.2**	120.0	120.0	90.0
Current account balance (% of GDP)									**6.3**	8.8	8.4	6.0
Fiscal balance (% of GDP)									**0.6**	0.5	0.4	1.0
Fiscal balance ex-social security (% of GDP)									**-2.0**	-2.1	-2.3	-1.0
BOK official base rate (%)	**1.75**	**1.50**	**1.50**	1.50	1.25	1.00	1.00	1.00	**2.00**	1.50	1.00	1.25
10-year T-bond yield (%)	**2.16**	**2.46**	**2.06**	2.25	2.20	2.15	2.25	2.35	**2.68**	2.25	2.35	2.50
Exchange rate (KRW/USD)	**1,109**	**1,124**	**1,185**	1,170	1,200	1,230	1,245	1,250	**1,099**	1,170	1,250	1,210

Note: Numbers in bold are actual values; others forecast. The "inventories" component contribution to GDP also includes statistical discrepancy. Interest rate and currency forecasts are end of period; others period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data as of 4 December 2015. Source: Bank of Korea, CEIC and Nomura Global Economics estimates.

Box 6: Forthcoming measures to encourage overseas portfolio investments

On 29 June 2015, the Ministry of Strategy and Finance (MOSF) unveiled measures to encourage overseas portfolio investments (i.e., capital outflows from Korean residents). In our opinion, the primary motivation for the move was policymakers' concerns over the relative strength of KRW against major trading partner currencies, as the current account surplus is expected to hit a record high in 2015-16.

The key measures are being put in place. The MOSF has submitted a tax bill to allow for the introduction of a "foreign equity investment fund" and the National Assembly is currently reviewing it. We believe the bill will be passed and become effective in January 2016. The Financial Supervisory Commission (FSC) will likely ease FX hedging regulations for insurance companies as early as April 2016, in our view. Unlike pre-2008, this time we believe unhedged overseas portfolio investment outflows from Korean residents will increase, for three main reasons.

First, FX profits on equity funds will be tax-exempt (Figure 23). In 2007, the government introduced similar tax breaks, but FX profits were not included. As a result, protection against KRW movements was a major selling point for retail clients. Many investment funds adopted high FX hedge ratios of about 75% (our estimate) of their net asset values (NAV) when the funds were set up. If their NAVs fall, they then need to buy USD to cover their hedging positions, and vice versa, assuming a constant hedge ratio. In 2007, there were large Korean retail flows to EM-focused equity funds, which caused strong demand for NAV FX hedging, and therefore ultimately had little impact on the FX spot market (Figure 24).

Second, the FSC is likely to allow Korean life insurance companies to hold some unhedged FX positions as early as April 2016, in our view. Currently, insurance companies need to hedge at least nine months of their FX-denominated long-term bond positions if asset durations are fully recognised in the asset-liability management ratio.

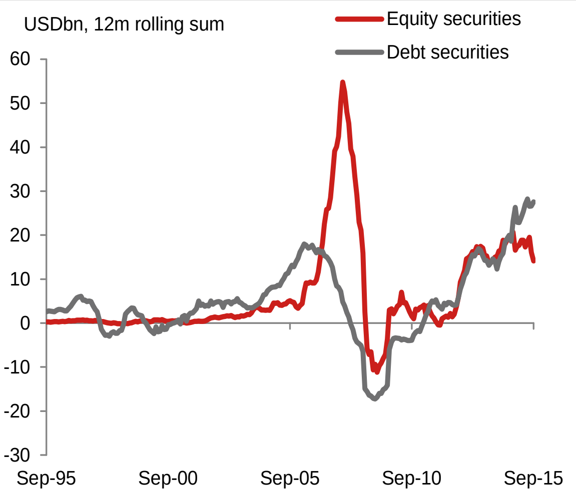
Third, the incentive for high FX hedging owing to FX forward premia (i.e., higher front-end KRW rates than USD) should fade considerably. Our monetary policy forecast for the Fed (three 25bp rate hikes from now to the end of 2016) and BOK (two 25bp rate cuts) suggests that USD/KRW forward premium should disappear as the front-end rate differential between Korea and the US narrows.

Fig. 23: Comparison of tax break in 2007 and 2016

		2007	2016
Type of income	Capital gains & appraisal profit	Tax-exempt	Tax-exempt
	FX profit	Taxed	Tax-exempt
Tax-exempt grace period		June 2007 to December 2009	Throughout investment (10 years)
Eligible funds	Existing fund	Yes	No
	Deadline for sign-up date	No deadline	2 years after the implementation
Ceiling on investment per person		No ceiling	30 KRW mn

Source: MOSF and Nomura Global Economics.

Fig. 24: Korean residents' overseas portfolio investment

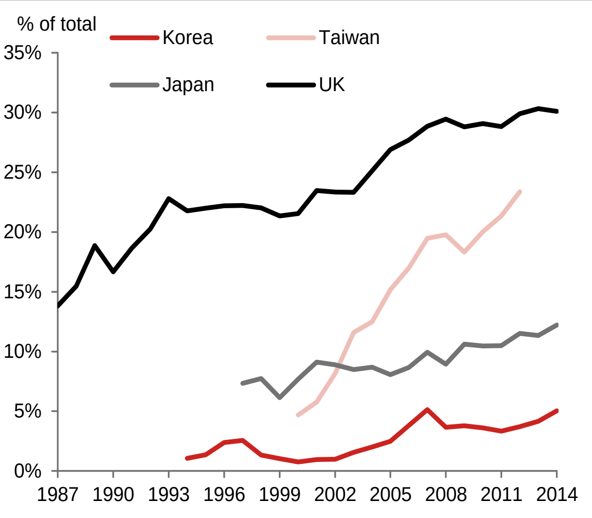


Source: CEIC and Nomura Global Economics.

Korean residents' overseas portfolio investment (excluding FX reserves) accounted for only 5% of total portfolio (domestic plus overseas) investment in 2014, well below that of other countries (Figure 25). From this vantage point and with the government policy incentives, we expect Korean retail and institutional investors to continue to increase their overseas portfolios. For example, Korea's National Pension Fund's (USD370bn asset under management) overseas portfolio accounted for 15% of total assets (foreign bond: 5%, foreign equities: 10%) in 2015, but it plans to increase the share to over 30% by 2020 – comparable with Japan's GPIF overseas asset allocation of 35% (foreign bond: 13%, foreign equities: 22%) in FY2014.

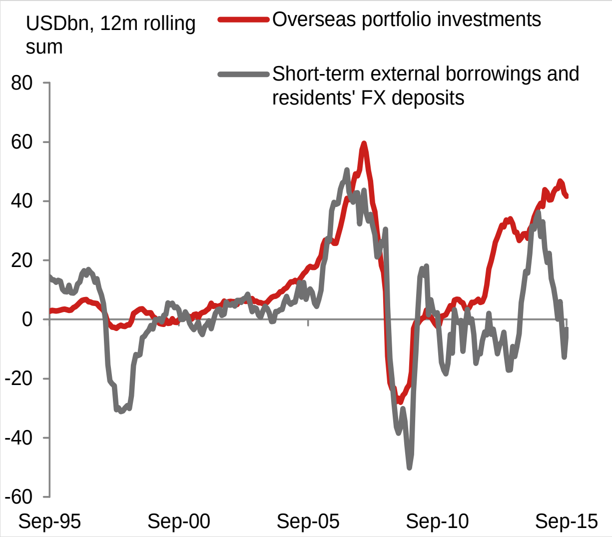
Before the 2008 global financial crisis, almost all portfolio outflows from Korean residents were FX hedged owing to tax considerations, regulations, FX forward premia and the expectation of a strong KRW. As a result, Korean residents' overseas portfolio outflows were well covered by short-term external borrowings and Korean residents' FX deposits (Figure 26). However, we expect Korean residents' overseas portfolio investment to likely consist of more unhedged capital outflows in 2016, especially if our out-of-consensus call (the BOK will deliver two 25bp rate cut to 1.00% by June 2016) proves correct.

Fig. 25: Portfolio outflows, % of total portfolio investment



Note: Total portfolio investment is the sum of domestic and overseas investments. Source: Nomura Global Economics.

Fig. 26: Overseas portfolio investment and external borrowing



Source: CEIC and Nomura Global Economics.

India: Both growth and macro risks to rise

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India has diverged from most other major EMs as 2015 saw it embark on what we judge to be a sustainable, multi-year economic recovery. In 2016, we expect growth to rise close to the economy's full potential. However, as the recommendations of the Seventh Pay Commission are implemented, we expect risks to the fiscal balance and to CPI inflation to rise, although the latter is mainly due to a one-off factor. Economic reforms are likely to continue in 2016, but incrementally, with executive decisions likely to take more of the spotlight. The main focus will be on the government's ability to implement the goods and services tax (GST), state elections in mid-2016 and redemptions of FCNR(B) dollar deposits in Q4 2016.

A consumption-driven growth recovery in 2016

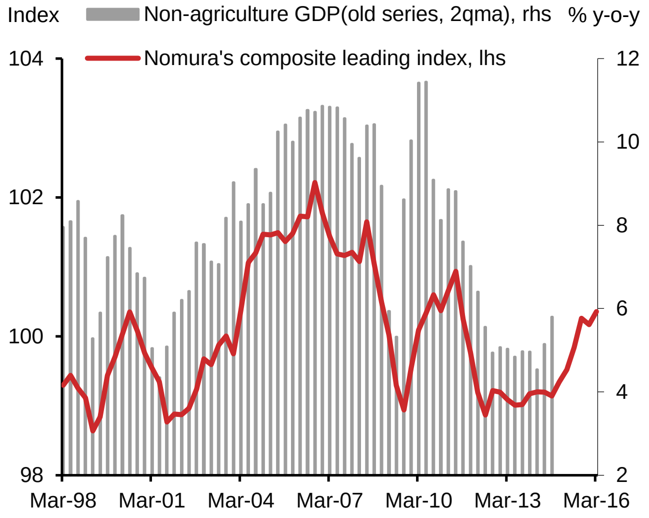
We expect India's GDP growth to rise from 7.3% in 2015 to 7.8% in 2016 and 8.0% in 2017, led by strengthening domestic demand. Under the new GDP series, we estimate India's potential growth at around 8%, which implies that the output gap will gradually narrow over the course of 2016, before closing fully by Q1 2017.

In our view, India is already in the initial stages of a business cycle recovery. Nomura's composite leading index, which historically has been a good indicator of non-agriculture GDP growth, suggests that growth will pick up in the next two quarters (Figure 27). The tailwinds from low commodity prices, low inflation, the gradual transmission of 125bp of cumulative rate cuts into lower bank lending rates, de-bottlenecking of stalled project clearances and government efforts to kick-start public investment in infrastructure should all help to keep the recovery on track.

We expect consumption demand to rise faster than capex in 2016. Higher real disposable incomes, lower borrowing costs and the income boost from the pay commission hike should boost urban consumer discretionary demand (see *India: Implications of the 7th Pay Commission recommendations*, 20 November 2015). A normal monsoon should also support rural consumption demand in H2 2016. Overall, we expect real private final consumption expenditure to rise to 8.4% from 7.6% in 2015.

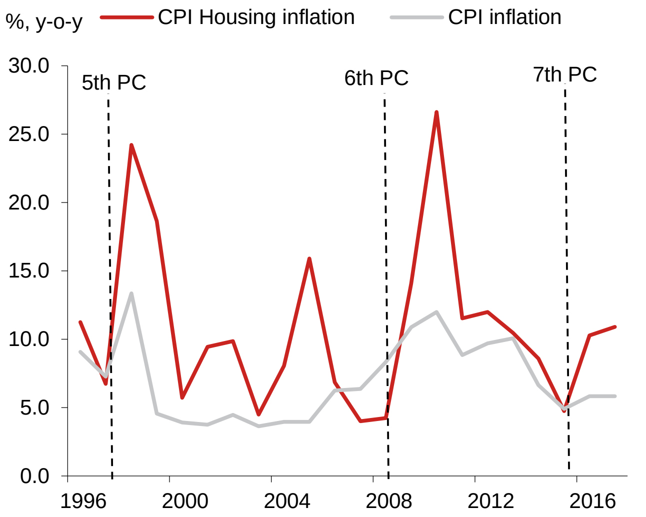
We expect the investment pick-up (6.3% growth in 2016 from 5.9%) to be led mainly by faster implementation of previously stalled projects (these have halved from equating to 2.2% of GDP at end-2014 to 1.1% in September 2015). Infrastructure investment growth in roads, railways and renewables should also start to rise. The government's budgeted capex is likely to be constrained in 2016 given the higher wage bill; so FDI inflows, bilateral/multilateral funding and public institutions will likely fund infrastructure projects. Given ample spare capacity in the manufacturing sector and high leverage, we do not expect a substantial acceleration in private sector capex, although higher profitability, lower funding costs and continued deleveraging should gradually repair private sector balance sheets.

Fig. 27: Nomura's composite leading indicator



Source: CEIC and Nomura Global Economics

Fig. 28: Pay commission (PC) and CPI inflation



Source: CEIC and Nomura Global Economics

Housing to push CPI inflation above the central bank's 5% inflation target

After falling from 6.6% in 2014 to 4.9% in 2015, we expect CPI inflation to rise again to 5.8% 2016, mainly on technical factors. We expect the steep rise in housing rental allowance (>100%) for central government employees (with states to follow), due to the Seventh Pay Commission, to push up CPI housing inflation from mid-2016 into mid-2017 (Figure 28). However, we expect the indirect inflationary impact from higher discretionary demand to be limited given low capacity utilisation in most sectors.

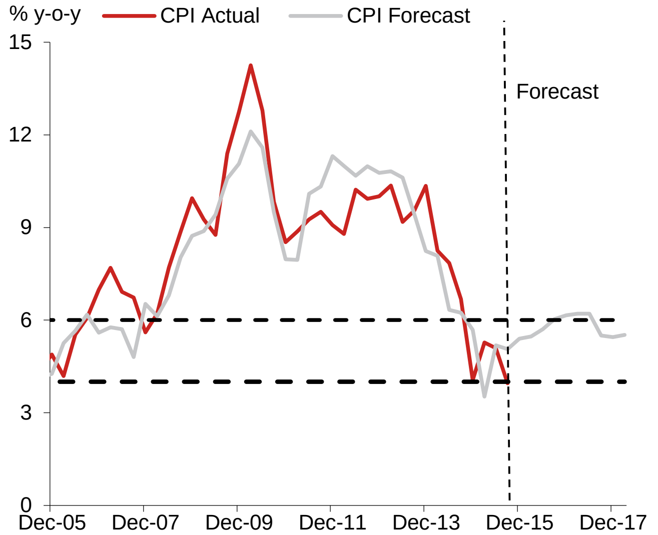
Excluding the one-off housing effect, underlying inflation (CPI ex- food, petrol/diesel) has been stable in the 5.0-5.5% range through the course of 2015. We do not expect any further disinflation in underlying CPI in 2016, because the drivers of lower inflation – a negative output gap, the sharp decline in commodity prices, lower rural wage growth and lower minimum support prices – have largely played out (Figure 29). As the output gap closes, we expect CPI inflation to stay stubbornly high, at 5.8% in 2017. In our view, steady-state inflation in India is still around 5.5% because of high inflation expectations (~10%) and little headway in supply-side reforms in agriculture to sustainably reduce food price pressures. Based on the assumption that commodity prices remain stable, we expect WPI deflation at -0.9% in 2016 versus -3.0% in 2015.

Quality of fiscal consolidation to suffer

The once-a-decade hike to government employee salaries and pensions will be implemented in FY17 (year starting April 2016) and we estimate will add a fiscal burden of 0.4% of GDP. The government has reaffirmed its commitment to fiscal consolidation, pledging to reduce the budget deficit from 3.9% of GDP in FY16 to 3.5% in FY17. In our view, achieving a smaller fiscal deficit along with a higher wage/pension bill is feasible only if these three criteria are all met: 1) capital expenditure is pruned (it is budgeted to rise by 25% in FY16); 2) service tax is hiked, along with higher excise/customs duties on other specific products; and 3) significantly higher asset sales are realised. While we expect the government to raise the service tax rate and budget higher asset sales, we believe an outright cutback in capex is unlikely given the need to revive public infrastructure investment. Rather, we envisage slower growth in capex than in 2015, alongside slight slippage in the fiscal deficit target to 3.6% of GDP in FY17.

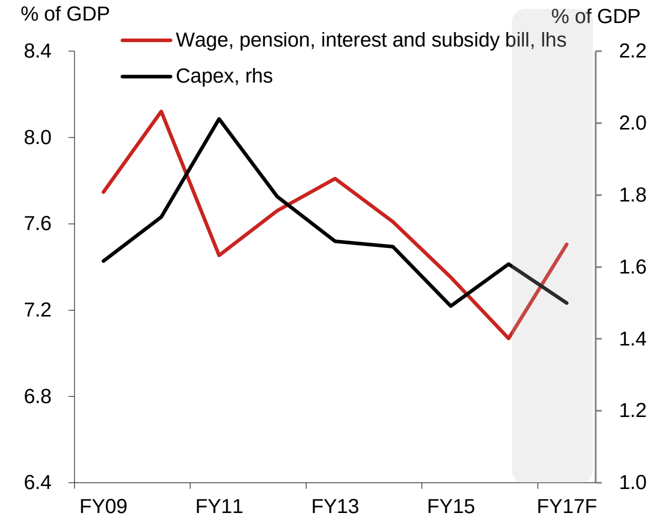
This implies that the quality of fiscal consolidation, which had improved in 2015, will once again suffer in FY17 with a higher mix of non-productive (inflationary) consumption spending and a slowdown in capex growth (Figure 30).

Fig. 29: CPI inflation: Actual vs forecast



Source: CEIC and Nomura Global Economics

Fig. 30: Quality of fiscal consolidation



Note: BE is budgeted, F: Nomura forecast
Source: CEIC and Nomura Global Economics

Policy rates to remain on hold

In our base case, we expect CPI inflation to remain well above the Reserve Bank of India's (RBI) 5% target in March 2017 (Nomura: 6.2%) and the 4% target in March 2018 (Nomura: 5.4%). Hence, we expect the RBI to keep policy rates on hold in 2016 as it has already delivered a cumulative 125bp of rate cuts in 2015. The pay commission recommendations have undoubtedly created upside risks to the RBI's targets. With inflation expectations still elevated, a growth recovery underway and upside risks to inflation, we do not see any space for further easing. Weaker quality of fiscal consolidation also suggests less need for monetary policy to be more accommodative.

Instead in 2016, we expect the RBI to focus on enabling greater monetary policy transmission by tackling the legacy impaired assets of the banking sector, making interest rates offered on small savings schemes market-determined and by moving to marginal cost-based pricing of loans. How monetary policy pans out will also depend on the composition of the new monetary policy committee (MPC). The draft Indian Financial Code has proposed a seven-member MPC (four government-appointed, others from the RBI). RBI Governor Rajan's three-year term comes to an end in September 2016 and it is not yet known if it will be extended.

Box 7: Effects of the last two pay commissions

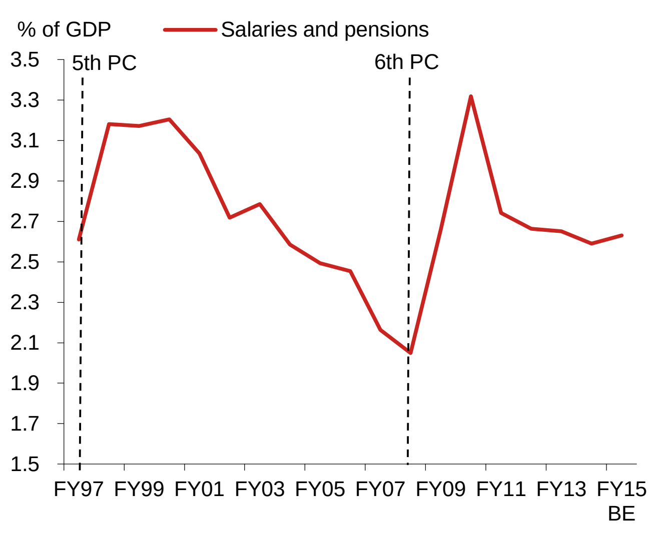
In the past, pay commissions have increased the government's fiscal burden, boosted consumer discretionary demand and pushed up CPI inflation.

For instance, both of the last two commissions raised the central government's wage and pension bill by 0.6% of GDP in the year of implementation, while the Sixth Pay Commission's staggered payment of arrears deducted a further 0.7% from GDP in the second year as well. Furthermore, fiscal pressures from pay commissions tend to spill to the states as most adopt their recommendations, albeit with some modifications. During the Fifth and Sixth Pay Commissions, state wage and pension bills rose by 1% of their GDP over the next two years.

The income boost received by government employees tends to raise demand for consumer discretionary items such as automobiles, clothing and footwear and some services. For example, in the two years following the Sixth Pay Commission, household expenditure on automobiles accelerated by over 20% y-o-y per year, compared to 7.4% in the year before. The Fifth Pay Commission sparked a sharp rise in expenditure on recreation services and education.

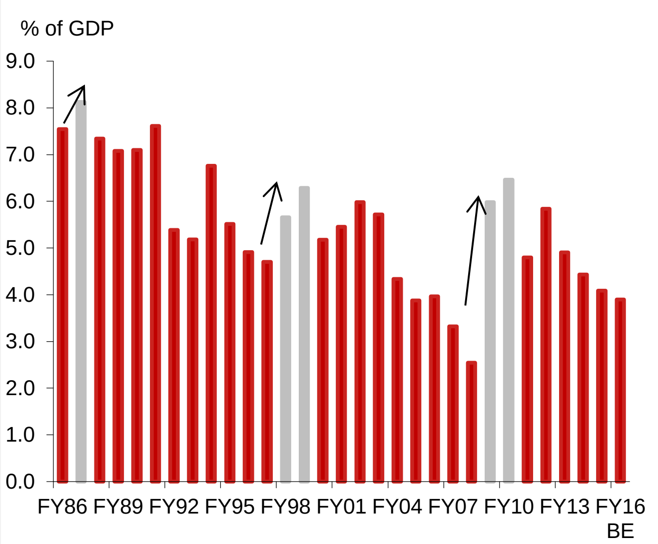
Historically, pay revisions have also resulted in a sharp rise in CPI inflation, for two reasons. First, they generally raise civil servants' housing rental allowance, which directly feeds into CPI housing inflation, and second, pay increases boost discretionary demand. For example, CPI services inflation rose by 300bp in a single year on the implementation of the Sixth Pay Commission recommendations.

Fig. 31: Central government: salaries and pensions (% of GDP)



Source: Ministry of Finance, CEIC and Nomura Global Economics

Fig. 32: Central government fiscal deficits



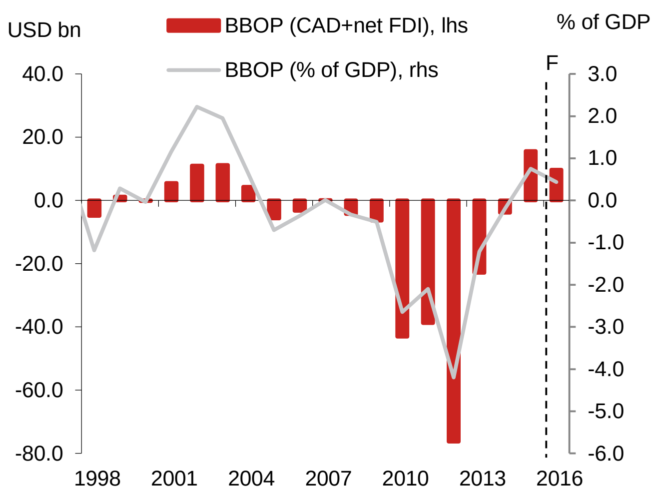
Source: Ministry of Finance, CEIC and Nomura Global Economics

A marginal current account deficit widening

Given the divergence between domestic growth (rising) and global growth (weak), we expect India's current account deficit to widen slightly from 0.9% of GDP in 2015 to 1.3% in 2016 and 2.1% in 2017. Export growth should remain subdued owing to weak foreign demand, whereas import growth is likely to pick up, mirroring rising domestic demand. Despite import volumes outpacing export volumes, we expect the current account deficit to remain contained owing to continued low commodity (particularly oil) prices.

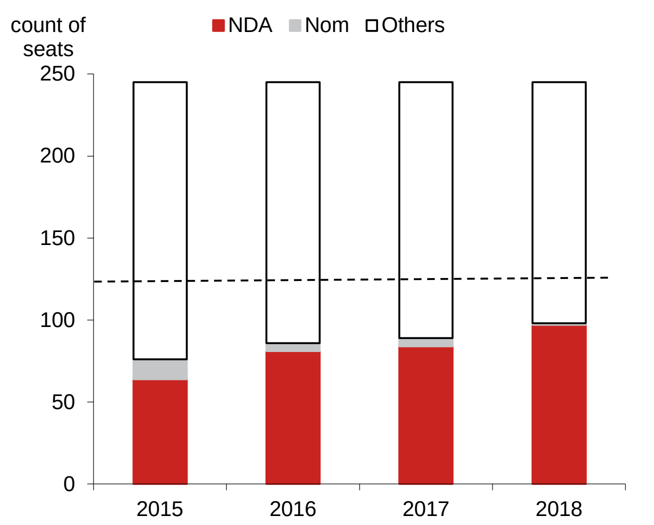
Financing the current account deficit should not be a challenge. We expect India's basic balance of payments (current account + net FDI) to remain positive in 2016 (Figure 33), as net FDI inflows rise due to the recent relaxation of FDI norms, a better domestic growth outlook and newer growth avenues (e-commerce, defence, railways, aviation, renewables). Also, growth-sensitive debt inflows should rise as domestic funding requirements pick up. Overall, we forecast India to have another large balance of payment surplus of around USD35bn in 2016. Other than India's vulnerability to oil and capital inflows, the redemption of USD25bn of FCNR(B) deposits in Q4 2016 could result in some volatility.

Fig. 33: Basic balance of payments (BBOP)



Note: 2016 is Nomura forecast. Source: CEIC and Nomura Global Economics

Fig. 34: BJP-led NDA's Upper House seat share



Note: Nom= nominated, NDA estimates include the nominated seats that will come up for re-election. The dashed line indicates the half-way mark (123 seats) in the Upper House. Source: Rajya sabha and Nomura Global Economics estimates

Incremental reforms to continue

Lack of an Upper House majority (the BJP has 64 of 245 seats) has made legislating reforms challenging. Our state-wise analysis suggests that the BJP-led National Democratic Alliance's (NDA) strength in the Upper House will rise gradually to around 80 (including nominated seats) by end-2016 (see *India: The Upper House arithmetic*, 10 November 2015), 84 by 2017 and 97 by 2018 (Figure 34). Hence, we believe the BJP's bargaining power will improve, but it will still need to build consensus with the opposition to push through legislative reforms.

Executive reforms should be easier. These include a focus on infrastructure development and subsidy rationalisation. We expect factor market reforms (land, labour) to be left to the states. Among the legislative reforms, if the GST constitutional amendment bill gets passed in the winter session, then we believe that GST could be implemented in Q3 2016. The bankruptcy code, strategic disinvestment and small savings deregulation are some of the other reforms in focus (see Box 8: Reforms in India to watch out for in 2016). Meanwhile, state elections (in Kerala, West Bengal and Tamil Nadu in April and May 2016) may slow policy announcements in Q2.

Risks

The key downside risks to our view are weak global growth, below-normal monsoon rains, higher commodity (oil and soft) prices, capital outflows and a hard landing in China. A sharper pick-up in investments and lower inflation are key upside risks.

Fig. 35: India: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP	**7.5**	**7.0**	**7.4**	7.4	8.4	7.1	7.5	7.9	7.3	7.8	8.0
Private consumption	**7.9**	**7.4**	**6.8**	8.5	8.0	8.5	8.8	8.5	7.6	8.4	8.8
Government consumption	**-7.9**	**1.2**	**5.2**	3.0	7.0	8.0	6.0	7.0	0.8	7.0	5.7
Fixed investment	**4.1**	**4.9**	**6.8**	8.0	6.5	6.0	6.2	6.5	5.9	6.3	6.6
Exports (goods & services)	**-8.2**	**-6.5**	**-4.7**	-4.0	3.0	4.8	5.3	4.3	-5.9	4.3	5.4
Imports (goods & services)	**-8.7**	**-5.4**	**-2.8**	-2.0	8.0	9.0	10.0	8.0	-4.7	8.8	9.3
Contributions to GDP (% points)											
Domestic final sales	**4.8**	**5.9**	6.6	7.6	6.9	7.7	7.6	7.6	6.2	7.4	7.6
Inventories	**2.5**	**1.3**	1.3	0.2	2.5	0.4	1.3	1.2	1.3	1.4	1.5
Net trade (goods & services)	**0.2**	**-0.2**	-0.4	-0.4	-1.1	-1.0	-1.3	-0.9	-0.2	-1.1	-1.0
Wholesale price index	**-1.8**	**-2.3**	**-4.5**	-3.3	-2.3	-1.8	-0.8	1.3	-3.0	-0.9	3.0
Consumer price index	**5.3**	**5.1**	**3.9**	5.4	5.5	5.7	6.0	6.2	4.9	5.8	5.8
Current account balance (% GDP)	**0.3**	**1.2**	1.4	0.9	0.3	1.1	2.0	1.7	-0.9	-1.3	-2.1
Fiscal balance (% GDP)									-3.9	-3.6	-3.3
Repo rate (%)	**7.50**	**7.25**	**6.75**	6.75	6.75	6.75	6.75	6.75	6.75	6.75	6.75
Reverse repo rate (%)	**6.50**	**6.25**	**5.75**	5.75	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Cash reserve ratio (%)	**4.00**	**4.00**	**4.00**	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
10-year bond yield (%)	**7.80**	**7.87**	**7.54**	7.60	7.40	7.40	7.50	7.50	7.60	7.50	7.50
Exchange rate (INR/USD)	**62.6**	**63.8**	**65.7**	66.7	66.9	67.2	67.3	67.4	66.7	67.4	65.0

Note: Numbers in bold are actual values; others forecast. The 'inventories' component in contribution to GDP also includes statistical discrepancy and valuables. Interest rate and currency forecasts are end of period; other measures are period average. Fiscal balance is on a fiscal year basis (2016 corresponds to FY17 or year-ending March 2017) Table reflects data as of 4 December 2015. Source: CEIC and Nomura Global Economics

Box 8: Reforms in India to watch out for in 2016

GST (probability of implementation in 2016: 65%): The goods and services tax (GST) is meant to simplify the tax regime by replacing a plethora of indirect taxes by a single unified tax. Once the GST Constitutional Amendment Bill is passed (requires a two-thirds majority), it has to be ratified by more than 50% of the state assemblies and then the revenue neutral rate has to be finalised (expected <18%).

Amendments to the RBI Act (70%): These include setting up a monetary policy committee (MPC) that votes on policy decisions. This may be implemented in H2 2016.

Strategic disinvestments (85%): The government is likely to fast-track stake sales in loss-making public sector companies. A mechanism for identifying strategic disinvestments (privatisation) in profitable public sector companies is also likely.

Bankruptcy code (60%): The bill includes setting up an insolvency regulator and adjudicating authority, early identification system for financial distress, an insolvency database and a clear timeline (180 days) and procedure (75% of creditors must approve the resolution plan) for resolving insolvency cases. This should facilitate better debt recovery for creditors and make it easier for investors and ailing companies to exit.

Infrastructure push (60%): We expect an independent railways regulator to be set up and station redevelopment to be the major focus. For roads, the focus will be on the hybrid annuity model to accelerate construction to 30km/day from the current 18km/day. In urban development, groundwork (greenfield or brownfield) for the development of 20 smart cities should begin. The Sagarmala project (ports) and the development of inland waterways should also progress further in 2016. We expect the National Infrastructure Investment Fund (INR200bn) to buy stressed projects in 2016.

Banking reforms (80%): Deregulation of small savings rates, privatisation of IDBI Bank and repos in the corporate bond market are all possible.

Labour reforms (70%): We expect amendments to the Child Labour Act (prohibiting employment of children under 14 years), the Factories Act (exempting factories with <40 employees from 14 labour laws, including easier shutdown) and an increase in the size of the employers provident fund.

Asean-5: Muddling through

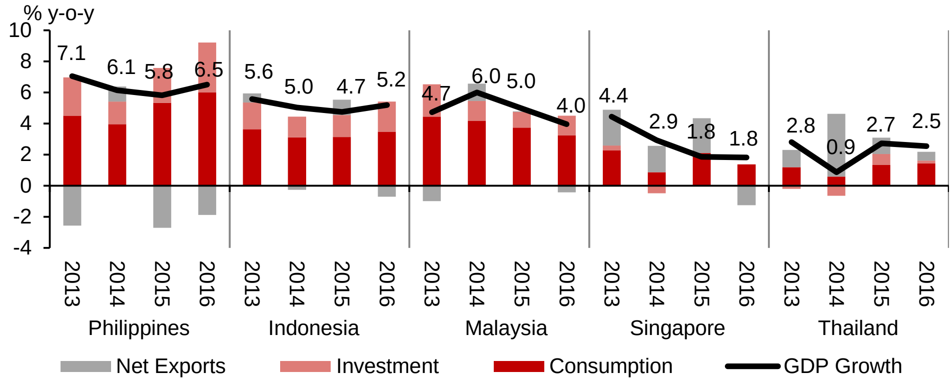
Overview

2015 turned out to be a particularly challenging year for the Asean region. Our two highest conviction calls for the year, which were firmly on the cautious side, worked well, namely Indonesian and Thai growth disappointed. However, even for the Philippines we scaled back our growth expectations while in Malaysia, despite the resilience of growth, negative investor sentiment was dominant, stoked by political uncertainty. In Singapore, growth is slowing to below trend, which itself is also declining.

As outlined in the Asia overview section, 2016 is unlikely to get any easier. However, we expect the Asean-5 to manage to muddle through and forecast GDP growth in aggregate at 4.4% in 2016 from 4.3% in 2015 (PPP-weighted). A key reason is that we have become constructive on the outlook for Indonesia, by far the largest economy in the region, forecasting a gradual growth recovery to 5.2% in 2016 and 5.6% in 2017, from 4.7% in 2015, due to more accommodative monetary and fiscal policies. The government's new root-and-branch, targeted approach to reforms should also result in better execution, and cumulatively help the investment climate.

Elsewhere, there is a great deal of divergence. We take into account the ability to support domestic demand via countercyclical policies and reform implementation as the main factor driving that differentiation amid an uncertain external outlook (Figure 36). We see private consumption as a key driver offsetting lower net export contributions, but we also now expect public investment spending to pick up, albeit still at an uneven pace (see Box 9: Asean – Building infrastructure… but at a varying pace), helping to crowd in private investment, alongside various reform measures.

Fig. 36: ASEAN GDP growth drivers



Source: CEIC; Nomura Global Economics

On that count, we remain most positive on the Philippines and most negative on Thailand. Political factors should drive a wedge further between these two because the Philippine elections are likely to be an additional catalyst for public investment, while in Thailand the drafting of the new constitution and the emerging political landscape may impede infrastructure spending and structural reforms, keeping business sentiment depressed. Malaysia remains in the neutral zone given its resilience: the drag from weaker export growth will likely be partly counterbalanced by investment spending and a turnaround in sentiment as political noise abates, with limited risk of fiscal reforms being reversed, supporting sovereign ratings further. On Singapore, we remain negative due to slower growth, rising inflation and still-weak productivity growth.

Countercyclical policy responses will likely be fairly commonplace. Headline inflation is rising across the region, but remains relatively benign and/or within respective targets. So despite a Fed lift-off expected in December, we expect 50bp of rate cuts in Indonesia and Thailand where real rates remain positive, and no change in the policy stance in Malaysia and Singapore throughout the year. Only in the Philippines do we expect rate hikes, totalling 50bp, given the solid growth outlook and upside risks to inflation. We expect fiscal deficits across the board, with Indonesia and the Philippines set for the most fiscal expansion as their governments focus on infrastructure implementation. Malaysia should be more constrained given the fiscal consolidation agenda, while in Thailand execution should be confined to fairly small stimulus measures.

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Box 9: Asean – Building infrastructure… but at a varying pace

In 2016 we expect an infrastructure upcycle to spread across the region, with virtually all Asean governments now more determined to make headway, devoting larger chunks of their budgets to capital expenditure and competing against each other to attract FDI. We forecast in Asean-5 total on-budget capex to reach 2.9% of GDP in 2016 (USD61bn) from an average 2.5% per annum in 2011-15.

However, successful implementation is still likely to vary significantly, in our opinion. Relative to their respective budgets, we expect realisation rates in Thailand and Indonesia to still lag, while Malaysia and the Philippines should be fairly close (Figure 37).

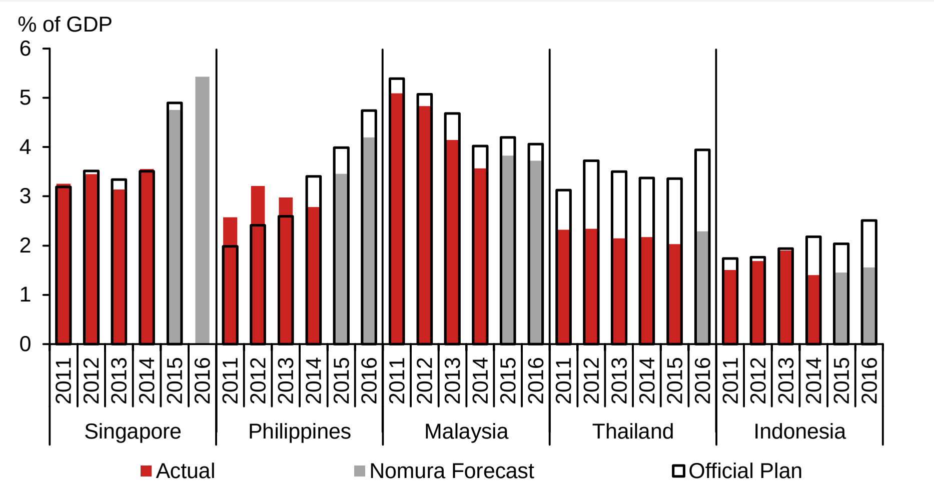
Malaysia stands out for its relatively effective implementation, with about 92% of the development budget actually spent between 2011 and 2014. This can be attributed to the fact that: it had a plan in the form of the Economic Transformation Programme; a single entity, Pemandu, was empowered to spearhead implementation and cut red tape; and the government had strong political will to push through implementation. In our view, with less political noise, a relatively high realisation rate is likely again next year.

Similarly, in the Philippines, the Aquino government prioritised infrastructure, aiming to double its capital outlays to 6.1% of GDP by 2018 from 3.0% in 2013. Initial progress was slow, partly because of the anti-corruption drive, but infrastructure spending is now gaining some momentum at an estimated 3.5% in 2015. A key feature is private investment spending rising in tandem, encouraging more participation in the projects under public-private partnership schemes, bolstering implementation further. The May 2016 national elections could be an additional catalyst to support the campaign of the administration's candidate in a bid to ensure policy continuity.

By contrast, because of the politics in Thailand, we expect weak implementation of public infrastructure spending in FY16. The military government is sticking to its ambitious off-budget infrastructure spending plan worth THB2.1trn (157% of GDP) over nine years. However, much of the execution falls to inefficient government agencies (see *Asia Insights - Postcard from Bangkok*, 26 October 2015) and unless institutional reforms are meaningfully carried out, we will expect it to fall short of targets. Due to the drafting of the new constitution the political environment could sour, hampering progress as these are multi-year projects that require sustained political stability.

In Indonesia, following a disappointing 2015, we believe the Jokowi administration will achieve higher capex realisation rates in 2016, although it will still remain below budget. While there has been some fiscal slippage due to shortfalls in tax revenue collection, the government's preference is increasingly to cut operating expenditure instead, departing from its previous practice of adjusting capex when fiscal space becomes more limited. Administrative constraints – mostly related to the transition to a new government and the re-organisation of line ministries – are also unlikely to persist into 2016 (see *Asia Special Report - Indonesia: Silver linings*, 25 November 2015).

Fig. 37: Planned, actual and likely disbursement of government capital spending



Note: We use development spending for Singapore and Malaysia; and capital spending for Philippines, Thailand (on-budget) and Indonesia. Singapore and Thailand are for FY16. There is no announced budget 2016 allocation yet for Singapore. Source: Various Ministries of Finance, CEIC, Nomura Global Economics.

Indonesia: A more growth-friendly policy mix

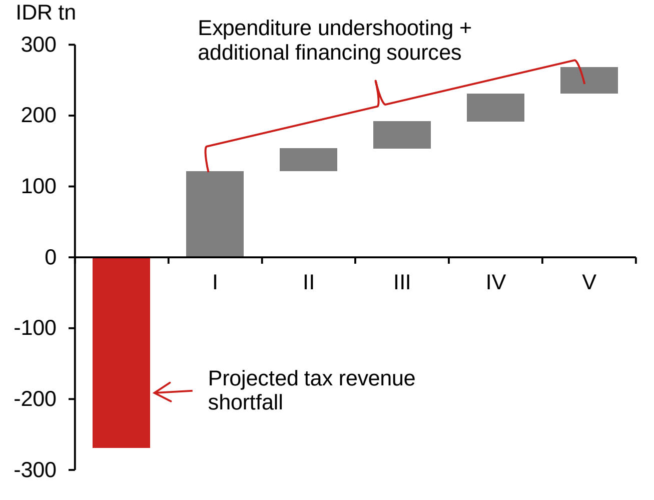
After taking a long-held cautious view on Indonesia's macro outlook, we are now turning more constructive due to more expansionary fiscal and monetary policies as well as a series of bite-sized reform measures that are looking more growth-friendly (see *Asia Special Report - Indonesia: Silver linings*, 25 November 2015).

Although they will take time bear fruit, we view the series of reform packages recently unveiled by the government following the cabinet re-shuffle in August as indicative of a more proactive streamlining of regulations to improve the investment climate. It also points to a more targeted approach, enhancing accountability and policy discipline, and hence we see a higher likelihood of better execution. The political backdrop is also becoming more favourable, with President Jokowi regaining some popularity and his coalition gaining a majority in parliament, which, as the recent budget debates showed, may be contributing to a less obstructionist stance by politicians.

At the same time, to provide more immediate stimulus, the government is stepping up disbursements of capex and removing bottlenecks, including early tendering of contracts and simplifying guidelines at the local government level. We now expect a steady climb in public capex growth, which we forecast to rise by 13.5% in 2015 (implying it accelerated by 15.5% y-o-y in Q4 versus 11% in Q1-Q3 2015) and then by 18% in 2016. This is despite the fact that tax revenue shortfalls are likely to remain substantial. Apart from tax reforms (which could still take time to generate significant revenues), the government's more immediate response is to generate fiscal space from other operating expenditures, tapping concession funding from standby multilateral facilities and allowing higher fiscal deficits (Figure 38). All of these are departures from past practices and strong fiscal conservatism (public debt at 24% of GDP is very low by global standards). As a result, we recently raised our fiscal deficit forecast to 2.6% of GDP in 2015 (from 2.1%), and to 2.7% in 2016 (from 1.7%), implying a fiscal impulse that remains positive.

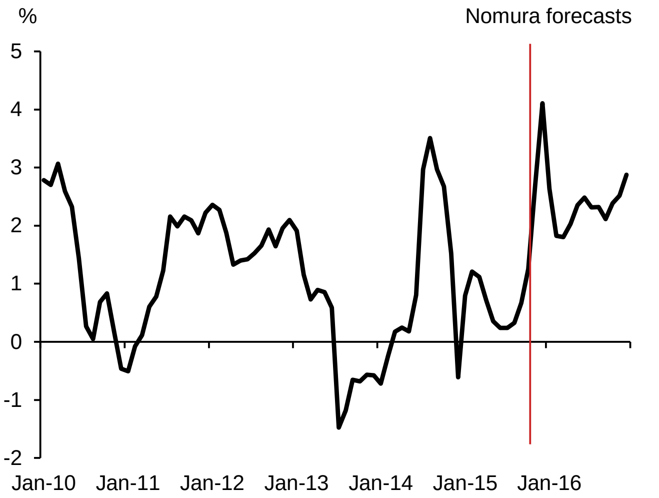
Monetary policy easing is also likely after an extended period in which Bank Indonesia (BI) maintained a hawkish stance despite slowing growth. We expect BI to cut its policy rate twice in quick succession soon after the expected December Fed lift-off for a total of 50bp of cuts by end-Q1 2016. Our forecast, while still contingent on a stable external backdrop, is supported by an expected drop in headline inflation (to 3.4% in December before averaging 4.7% in 2016, within BI's 3-5% target) that will boost real rates (Figure 39) and our current account deficit forecasts which we lowered to 1.9% and 2.3% of GDP in 2015 and 2016 from 2.6% and 3.5%, respectively.

Fig. 38: Indonesia: Nomura estimates of main fiscal items relative to the 2016 budget



Note: I =capex undershooting; II = savings in other operating expenditures; III = savings in regional transfers; IV = increase in net government securities issuance; V = increase in foreign program/project loans. Source: MOF, Nomura Global Economics estimates

Fig. 39: Indonesia: Real policy rate



Note: Real policy rate is the BI rate minus headline inflation (% y-o-y). Source: CEIC; Nomura Global Economics estimates.

Given more expansionary macro policies, we think a gradual growth recovery is now likely, starting in Q4 2015, when we expect a modest domestic demand-led improvement, before gaining further traction in 2016 (Figure 40). Consequently, we have raised our 2016 GDP growth forecast from 4.7% to 5.2%, putting us ahead of the consensus forecast of 4.9%. We have also lifted our 2017 GDP growth forecast from 5.1% to 5.6%.

Nonetheless, there are still a few risk factors that require close monitoring. These include delays in public capex implementation, a larger-than-expected tax revenue shortfall, renewed currency weakness, slower Chinese growth, a further drop in commodity prices, and the associated increase in pressures on corporate balance sheets. These risks notwithstanding, we are equally cognisant that they are well known in the market, that long-term investors are scouring the globe for yield and that most other large, high-yielding EM economies are in worse shape than Indonesia. Amid increasing discrimination by global EM investors, a small change in outlook could have a disproportionately larger impact on investor flows than in the past.

Fig. 40: Indonesia: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP (sa, % q-o-q, annualised)	**4.2**	**4.8**	**5.0**	5.1	4.9	5.1	5.5	5.4			
Real GDP	**4.7**	**4.7**	**4.7**	4.8	4.9	5.1	5.3	5.4	4.7	5.2	5.6
Private consumption	**4.7**	**4.7**	**5.0**	5.0	5.2	5.2	5.3	5.3	4.9	5.2	5.2
Government consumption	**2.7**	**2.1**	**6.6**	6.8	5.7	6.5	6.7	6.8	4.9	6.5	7.0
Gross fixed capital formation	**4.4**	**3.7**	**4.6**	4.9	5.2	5.7	6.4	6.6	4.4	6.0	8.0
Exports (goods & services)	**-1.0**	**-0.1**	**-0.7**	-0.8	-1.4	-1.5	-1.9	-3.0	-0.7	-2.0	0.8
Imports (goods & services)	**-2.4**	**-7.0**	**-6.1**	-4.2	-1.3	1.5	2.1	2.6	-4.9	1.3	4.0
Contributions to GDP (% points)											
Domestic final sales	**4.2**	**3.9**	**4.7**	5.3	4.9	5.2	5.5	6.0	4.5	5.4	6.1
Inventories	**0.2**	**-0.9**	**-1.2**	-1.3	0.1	0.6	0.6	0.7	-0.8	0.5	0.1
Net trade (goods & services)	**0.3**	**1.6**	**1.2**	0.8	-0.1	-0.6	-0.8	-1.3	1.0	-0.7	-0.6
Consumer prices	**6.5**	**7.1**	**7.1**	4.8	4.8	4.5	4.8	4.8	6.4	4.7	4.8
Exports (BOP basis)	**-13.9**	**-10.8**	**-17.4**	-10.0	-4.6	-4.2	-4.6	-4.9	-13.0	-4.6	0.5
Imports (BOP basis)	**-14.3**	**-20.8**	**-24.0**	-15.0	-4.9	-2.5	1.1	2.2	-18.6	-1.1	5.0
Trade balance (US$bn, BOP basis)	**3.1**	**4.1**	**4.1**	4.3	3.0	3.4	2.1	1.6	15.5	10.1	4.0
Current account balance (US$bn)	**-4.1**	**-4.2**	**-4.0**	-3.7	-4.1	-5.1	-5.3	-5.5	-16.1	-20.0	-26.5
Current account balance (% of GDP)	**-1.9**	**-1.9**	**-1.9**	-1.8	-1.9	-2.3	-2.3	-2.5	-1.9	-2.3	-2.8
Fiscal Balance (% of GDP)									-2.6	-2.7	-2.5
Unemployment rate (nsa, %)	**5.8**	**5.8**	**6.2**	6.2	6.2	6.1	5.8	5.7	6.0	6.0	5.8
Bank Indonesia rate (%)	**7.50**	**7.50**	**7.50**	7.50	7.00	7.00	7.00	7.00	7.50	7.00	6.50
Exchange rate (IDR/USD)	**13074**	**13339**	**14653**	14000	14200	14450	14650	14850	14000	14850	14600

Notes: Numbers in bold are actual values; others forecast and inventories under the GDP components also includes statistical discrepancy. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015. Source: CEIC and Nomura Global Economics.

Malaysia: Sentiment likely turning the corner

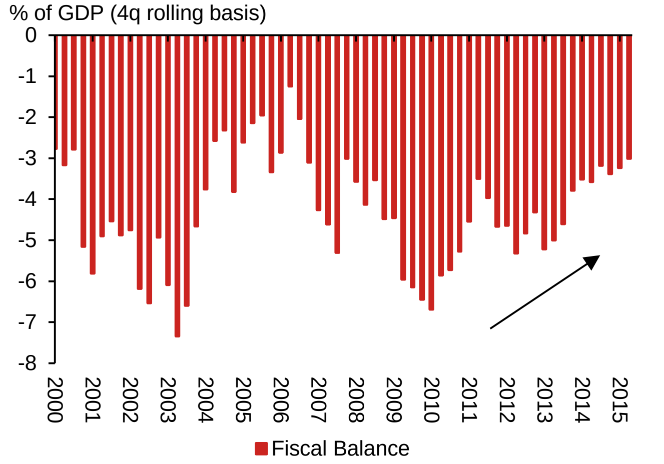
We have had a relatively sanguine view on Malaysia's economic outlook all year, keeping it at 'neutral' in our league table for all of 2015, despite the political noise and resultant weakness in sentiment. For 2016, we find no reason to change this view – growth will likely moderate, but considering the external environment, low commodity prices and ongoing fiscal consolidation (albeit at a slower pace), this is a resilient outcome. Against that backdrop, we expect market sentiment to improve as political uncertainty dissipates and commodity prices stabilise, albeit at low levels.

We forecast GDP growth to moderate to 4.0% in 2016 from 5.0% in 2015, reflecting our weaker growth assumption for China, which poses headwinds to export growth and commodity prices. However, the US recovery and improved export competitiveness from MYR depreciation should continue to support manufactured exports – a key source of economic resilience. Domestically, ongoing projects under the Economic Transformation Program (ETP) and the substantial government budget for development spending should support fixed investment (see *Asia Insights - Malaysia: Slower pace of fiscal consolidation*, 23 October 2015). All this is consistent with our forecast for the current account to remain firmly in surplus of about 2.7% of GDP in 2016, broadly stable from 2.8% in 2015 (official forecasts: 1.5-2.5% in 2015 and 0.5-1.5% in 2016).

We believe the government will comfortably meet its 2016 fiscal deficit target of 3.1% of GDP and, importantly, we see limited risk of a reversal in fiscal reforms. There are upside risks to revenues given the budget's fairly conservative oil price assumption of USD48/bbl in 2016 and the excise duty hike on cigarettes by over 40%. Moreover, the sensitivity of revenue to oil price changes has dropped since the implementation of the goods & services tax (GST), which the government projects will account for 17% of revenues in 2016, diversifying the revenue base materially. That said, should revenues exceed expectations it should be growth-friendly as, rather than reduce the deficit further, we would expect the government to channel any extra revenue to fund higher operating expenditure, partly in an effort to claw back some of Prime Minister Najib Razak popular support.

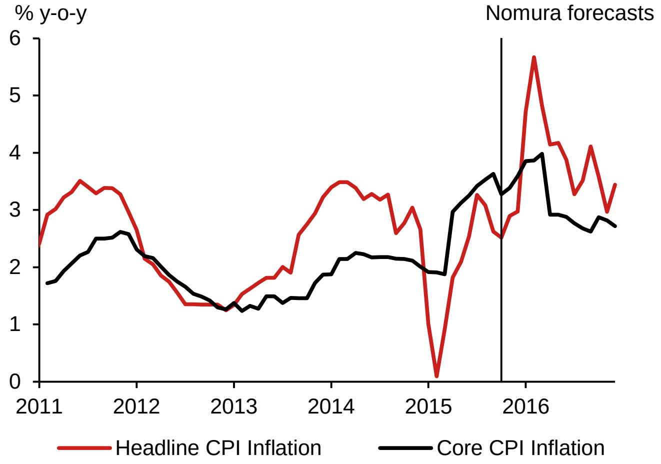
With this in mind, we expect headline inflation to remain elevated at 4.0% in 2016, from around 2.2% in 2015. This incorporates numerous subsidy cuts in 2016[3] and base effects from lower oil prices, which could drive Q1 2016 inflation up to 5.1%. However, Bank Negara Malaysia (BNM) will likely look past these factors – core inflation, for example, should remain broadly stable and then moderate in April (Figure 42). We expect the policy rate to remain unchanged in 2016, with BNM still seeing the policy stance as accommodative at a time when it is also projecting slower growth of 4-5% next year.

Fig. 41: Malaysia: Fiscal balance



Source: CEIC, Nomura Global Economics.

Fig. 42: Malaysia: Headline and core inflation forecasts



Source: CEIC, Nomura Global Economics estimates.

On politics, our baseline remains that a change in regime is unlikely and that Prime Minister Najib remains in office, at least until the next general election, which has to be held by 2018. If anything, we believe there is scope for the significant political concerns that shrouded this year to dissipate. The Sarawak state elections must be held by 20 September 2016 and Mr Najib's party, the United Malays National Organisation (UMNO), will likely face greater pressure to appear united going into the election rather than openly feuding with the prime minister (see *Asia Insights - Malaysia: Political noise rising again*, 15 October 2015). The 1Malaysia Development Berhad (1MDB) debt rationalisation plans are also already bearing fruit and could allow political noise to fade.

[3] While not mentioned in the budget speech or the economic report published by the ministry of finance, budget documents detailing expenditure estimates for individual ministries show the 2016 allocations for a number of subsidies – including those for rice, cooking oil and electricity tariffs – have been completely cut.

Fig. 43: Malaysia: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP (sa, % q-o-q, annualized)	**4.7**	**4.5**	**2.6**	6.6	3.4	3.8	2.6	4.0			
Real GDP	**5.6**	**4.9**	**4.7**	4.6	4.3	4.1	4.1	3.4	5.0	4.0	4.1
Private consumption	**8.8**	**6.4**	**4.1**	3.5	3.5	4.5	5.5	6.0	5.6	4.9	6.0
Government consumption	**4.1**	**6.8**	**3.5**	8.5	4.0	4.0	6.0	5.5	6.0	5.0	6.0
Gross fixed capital formation	**7.9**	**0.5**	**4.3**	3.5	3.5	7.0	5.0	4.0	3.9	4.9	6.0
Exports (goods & services)	**-0.6**	**-3.7**	**3.2**	4.5	1.2	2.7	0.7	-0.3	0.9	1.1	2.0
Imports (goods & services)	**1.0**	**-2.8**	**3.2**	2.4	2.6	3.5	0.1	1.5	1.0	1.9	3.1
Contributions to GDP (% points)											
Domestic final sales	**7.1**	**4.2**	**3.7**	4.1	3.3	4.7	5.0	5.0	4.7	4.5	5.6
Inventories	**-0.4**	**1.7**	**0.7**	-1.2	1.8	-0.4	-1.4	-0.4	0.2	-0.1	-0.9
Net trade (goods & services)	**-1.1**	**-1.0**	**0.3**	1.8	-0.8	-0.2	0.5	-1.2	0.0	-0.4	-0.6
Unemployment rate (% sa)	**3.1**	**3.1**	**3.3**	3.3	3.3	3.3	3.3	3.3	3.2	3.3	3.3
Consumer prices	**0.7**	**2.2**	**3.0**	2.8	5.1	4.1	3.6	3.3	2.2	4.0	2.0
Exports (BOP basis)	**-10.9**	**-16.4**	**-17.8**	-14.9	-5.9	-7.6	-1.0	3.9	-15.1	-2.7	4.5
Imports (BOP basis)	**-8.9**	**-14.9**	**-18.0**	-18.2	-8.3	-8.9	-3.7	0.7	-15.1	-5.2	3.1
Trade balance (US$bn, BOP basis)	**7.6**	**6.4**	**6.7**	8.8	8.1	6.3	7.6	10.3	29.5	32.3	35.7
Current account balance (US$bn)	**2.8**	**2.1**	**1.2**	2.2	1.4	1.9	2.1	2.2	8.3	7.7	7.9
Current account balance (% of GDP)	**3.6**	**2.7**	**1.7**	3.1	2.0	2.6	3.0	3.1	2.8	2.7	2.7
Fiscal Balance (% of GDP)	**-4.2**	**-1.4**	**-1.6**						-3.2	-3.1	-2.8
Overnight policy rate (%)	**3.25**	**3.25**	**3.25**	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50
Exchange rate (MYR/USD)	**3.72**	**3.79**	**4.45**	4.20	4.23	4.31	4.36	4.40	4.20	4.40	4.28

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015.
Source: CEIC and Nomura Global Economics.

Philippines: A tight race supports growth

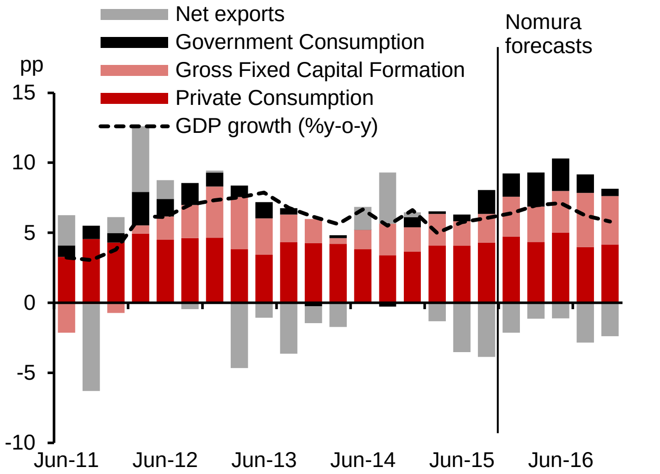
We have had a long-standing positive view on the Philippines, but we see 2016 putting it to the test given external factors and the domestic political cycle. However, our view is anchored on the growth outlook which is still firmly on an upward path, making it a standout in the region. Equally important is the improving quality of growth, with rising contributions from investment spending (Figure 44). Following the weaker-than-expected GDP outturn in Q3 2015, we scaled back our GDP forecasts but maintained an upward trajectory: we forecast 2016 growth to rise to 6.5% from 5.8% in 2015. This partly reflects our view that the elections in May 2016 will likely boost already healthy domestic demand, rather than act as a headwind. For 2017, we forecast growth to moderate to a still-robust 5.8% as the impact of election-related spending fades and public-sector spending slows as the new government transitions into office.

While the final line-up of leading presidential candidates could still change (see *First Insights - Philippines: The list of presidential candidates could still change*, 2 December 2015), the race looks like it will boil down to five candidates: opposition standard bearer Jojo Binay, the administration's candidate Mar Roxas, independent Grace Poe, independent Miriam Santiago and Rodrigo Duterte.[4] We expect this to be a tight contest because of the respective strengths of the three main candidates – Ms Poe is most popular despite being the least experienced; Mr Binay is strong at the grassroots level; and Mr Roxas has the backing of the government. Senator Miriam Santiago and Mayor Rodrigo Duterte are strong characters but in our view may lack the political machinery to run an effective national campaign, although both could potentially creep into the support base of the other three, especially Duterte who in recent surveys has gained popularity.

A tight race should impel outgoing President Aquino to step up efforts to support Mr Roxas, who is comparatively weaker in the polls – an obvious way would be to provide more fiscal support to growth, particularly on infrastructure projects, which have already been a strong focus for him. We continue to forecast a larger fiscal deficit of 2.0% of GDP in 2016 from 0.7% in 2015. Meanwhile, apart from some uncertainty about the outcome, our baseline is that, given the orderly process in 2010 and 2013 under an electronic vote-counting system, we expect free and fair elections, with limited incidence of violence or risk of widespread fraud.

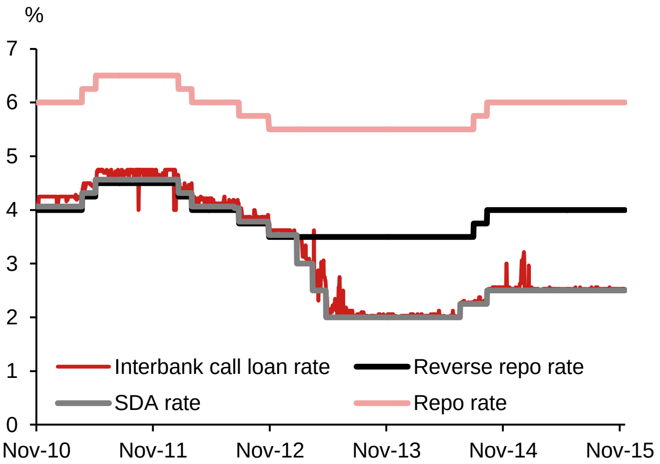
[4] Duterte (from Davao, the third-largest city) filed his candidacy after the October deadline as a "substitute" candidate despite repeatedly saying he is not running for office. There are some questions whether his candidacy may be ultimately approved by the Commission on Elections.

Fig. 44: Philippines: GDP contributions by expenditure



Source: CEIC, Nomura Global Economics.

Fig. 45: Philippines: Monetary policy corridor



Source: Bloomberg, Nomura Global Economics

A current account surplus and, importantly, durable FDI inflows should continue to provide significant buffers against external risks. Low oil prices, resilient worker remittances, and rapidly growing business process outsourcing and tourism sectors should partly offset rising import demand given the strength of the domestic economy. Importantly, we expect FDI inflows to continue to rise despite the political transition, driven by fundamental factors such as further progress in infrastructure implementation, liberalisation of banking ownership and the roadmap for developing the auto sector.

Similar to GDP growth, we are scaling back our CPI inflation forecasts to 1.4% in 2015 (from 2.0%) and to 2.7% in 2016 (from 3.2%). Our forecast path suggests that inflation bottomed in October (at 0.4%), and should persistently rise (to 3.5% in Q4 2016 versus the 2-4% inflation target) on a combination of food prices creeping higher in Q1, increased demand in the run-up to the May elections and the base effects from the oil price impact turning less favourable by H2.

Given these forecast changes, we also adjust our policy rate forecasts. We still see a case for policy rate hikes given the positive growth outlook, but judge that these are now unlikely to begin in Q1, as we previously forecast. We reduce the magnitude of our policy rate hike forecasts from a total of 100bp in 2016 to 50bp, starting with a 25bp increase in Q2 and another in Q3, taking the reverse repo (RRP) rate to 4.5%.

We expect the Q2 move to coincide with an announced formalisation of a shift to a policy corridor framework by Q2 2016. A 25bp hike in the RRP rate would make the policy corridor symmetrical (i.e. the corridor width is 175bp – Figure 45) which, as we have argued before, is a starting point BSP would prefer (see *Asia Insights: Philippines: Moving to a policy corridor*, 21 March 2013). Given our expected inflation and growth dynamics at that time, we believe the announcement of the shift is more likely to result in an increase in policy rates rather than a cut. Thereafter, the next RRP rate hike we forecast in Q3 will likely be accompanied by an equivalent shift in both the floor (SDA rate) and ceiling (RP rate) of the new corridor.

Fig. 46: Philippines: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP (sa, % q-o-q, annualized)	**2.0**	**8.2**	**7.8**	10.4	3.4	4.3	9.4	7.6			
Real GDP	**5.0**	**5.8**	**6.0**	6.4	7.0	7.1	6.2	5.8	5.8	6.5	5.8
Private consumption	**6.0**	**6.2**	**6.3**	6.5	6.3	7.5	5.8	5.7	6.2	6.3	6.0
Government consumption	**1.7**	**3.9**	**17.4**	21.0	23.3	19.9	12.2	5.7	10.1	15.5	6.3
Gross fixed capital formation	**10.0**	**8.9**	**9.3**	13.0	10.7	14.6	17.0	15.0	10.4	14.3	7.5
Exports (goods & services)	**6.4**	**2.1**	**6.4**	7.9	6.6	9.2	4.0	3.6	5.6	5.9	4.5
Imports (goods & services)	**8.7**	**10.4**	**13.5**	11.7	8.3	11.8	8.7	8.2	11.1	9.2	6.0
Contribution to GDP growth (% points)											
Domestic final sales	**6.5**	**6.3**	**8.0**	9.2	9.3	10.3	9.2	8.1	7.6	9.2	6.7
Inventories	**-0.2**	**3.0**	**1.8**	-0.7	-1.2	-2.1	-0.1	0.0	1.0	-0.8	0.2
Net trade (goods & services)	**-1.3**	**-3.5**	**-3.9**	-2.1	-1.1	-1.1	-2.8	-2.4	-2.7	-1.9	-1.0
Exports	**-0.2**	**-8.3**	**-8.1**	1.6	2.9	1.4	3.6	2.9	-3.9	2.7	4.5
Imports	**-4.0**	**-1.6**	**11.6**	3.3	7.3	5.1	6.0	7.4	2.5	6.5	6.0
Merchandise trade balance (USDbn)	**-1.5**	**-0.4**	**-3.8**	-1.8	-2.2	-0.9	-4.4	-2.6	-7.4	-10.1	-11.7
Current account balance (USDbn)	**1.9**	**2.8**	3.5	3.8	3.5	3.6	2.4	0.9	11.9	10.3	9.6
Current account balance (% of GDP)	**2.7**	**3.8**	4.9	4.6	4.9	4.6	3.1	0.9	4.0	3.3	2.8
Fiscal balance (% of GDP)									-0.7	-2.0	-2.3
Consumer prices (2006=100)	**2.4**	**1.7**	**0.6**	0.9	1.8	2.3	3.1	3.5	1.4	2.7	3.5
Unemployment rate (sa, %)	**6.6**	**6.4**	**6.5**	6.4	6.3	6.2	6.1	6.0	6.5	6.2	6.2
Reverse repo rate (%)	**4.00**	**4.00**	**4.00**	4.00	4.00	4.25	4.50	4.50	4.00	4.50	5.00
Exchange rate (PHP/USD)	**44.8**	**45.2**	**46.9**	47.1	47.3	47.6	47.9	48.1	47.1	48.1	46.8

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015.
Source: CEIC and Nomura Global Economics.

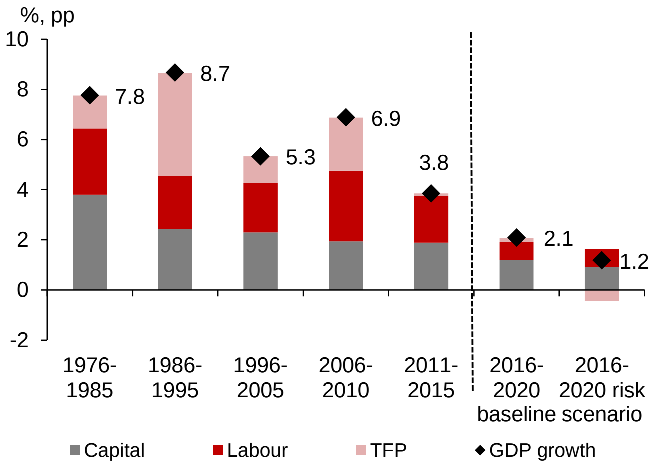
Singapore: Slow growth but rising inflation

We are lowering Singapore's economic outlook to the 'negative' camp from 'neutral' due to the spectre of falling growth and rising inflation pressures. While the economy avoided a technical recession in 2015 with Q3 GDP growth of 1.9% q-o-q saar, we struggle to find cause for greater optimism in 2016 as we expect global growth to remain tepid, domestic interest rates to rise in tandem with the Fed's rate-hike cycle, and the residential property market to continue to slow. With both domestic and external demand likely to struggle in 2016, we expect GDP growth to remain subdued at 1.8%, similar to 2015.

The labour market will likely remain tight as labour-supply growth is also slowing sharply because of tight foreign labour policies (i.e., restrictions) and a rapidly ageing population as highlighted in the Asia overview section. With employment growth slowing, the burden of driving GDP growth increasingly falls on productivity growth which has been disappointing, despite the government's economic restructuring agenda in place since 2010 (see *Asia Special Report – Singapore's productivity conundrum*, 23 October 2015). Given weak global demand, tightening financial conditions after a Fed lift-off and deteriorating demographics, we expect productivity growth to remain lacklustre. We estimate Singapore's potential growth to slow to 2.1% in 2016-20 from 3.8% in 2011-15 (Figure 47).

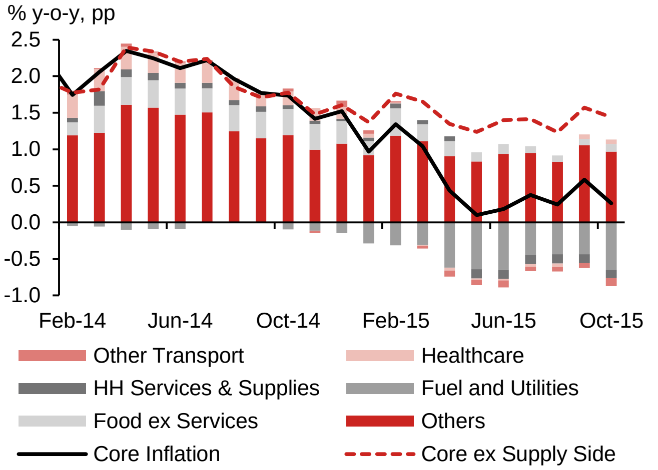
Headline CPI will likely remain negative at -0.1% in 2016 (from -0.5% in 2015) with deflationary forces from a decline in car Certificate of Entitlement quota premiums and a weaker property market. However, this masks firm underlying price pressures (Figure 48) because of a persistently tight labour market which will likely rise as firms are forced to eventually pass on rising unit labour costs to consumer prices, despite tepid demand. We expect core CPI inflation to rise from an estimated 0.5% in 2015 to 1.0% in 2016, the mid-point of the official 0.5-1.5% forecast.

Fig. 47: Singapore: Estimated potential output growth



Note: The "risk scenario" shows our estimates if our global growth forecast is cut by 0.5pp. Source: Nomura Global Economics estimates.

Fig. 48: Singapore: Core inflation ex- supply-side factors



Note: To account for these supply-side factors, we exclude food excluding food-servicing services, fuel & utilities, other travel & transport, healthcare and household services & supplies from core inflation. Source: CEIC, Nomura Global Economics.

Monetary policy will become increasingly hamstrung, in our view, while fiscal policy, by contrast, should become more active. Rising core inflation will probably pose a high hurdle for the Monetary Authority of Singapore (MAS) to ease FX policy further despite slower growth. Meanwhile, we believe the government will likely have to run another fiscal deficit in FY16 of about 0.2% of GDP from 1.0% in FY15, if it is to fund efforts to incentivise productivity improvements and continue to invest in transport and healthcare infrastructure. Foreign worker levy hikes scheduled for July 2016 may be delayed further, while the SkillsFuture initiative will likely be expanded to encourage Singaporeans to undertake more education and training. These will likely pave the way for new policy recommendations in December 2016 from the Future Economy committee, tasked to review policies to spur economic restructuring.

Fig. 49: Singapore: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP (sa, % q-o-q, annualized)	**3.5**	**-2.6**	**1.9**	0.9	2.5	2.5	2.3	2.9			
Real GDP	**2.7**	**2.0**	**1.9**	0.9	0.7	2.0	2.0	2.6	1.8	1.8	1.8
Private consumption	**3.3**	**3.8**	**5.2**	5.5	4.0	3.5	2.0	3.0	4.5	3.1	3.5
Government consumption	**4.9**	**1.5**	**12.5**	5.0	10.0	-2.0	-3.0	4.0	6.0	2.8	1.3
Gross fixed capital formation	**-2.2**	**4.1**	**0.2**	-2.3	-0.8	-1.1	0.6	0.4	-0.1	-0.2	0.8
Exports (goods & services)	**4.4**	**1.1**	**3.2**	4.2	0.7	1.7	1.2	0.6	3.2	1.1	0.2
Imports (goods & services)	**-0.4**	**-0.4**	**6.0**	4.5	4.2	3.0	0.5	0.4	2.4	2.0	0.2
Contributions to GDP (% points)											
Domestic final sales	**1.1**	**2.4**	**2.9**	1.8	2.4	0.8	0.6	1.6	2.1	1.3	1.6
Inventories	**-7.6**	**-3.2**	**2.4**	-1.5	3.7	2.8	0.0	0.4	-2.5	1.7	0.3
Net trade (goods & services)	**9.1**	**2.8**	**-3.5**	0.6	-5.4	-1.7	1.5	0.6	2.2	-1.2	0.0
Unemployment rate (sa, %)	**1.8**	**2.0**	**2.0**	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Consumer prices	**-0.3**	**-0.4**	**-0.6**	-0.8	-0.4	-0.5	0.0	0.5	-0.5	-0.1	0.2
Exports (BOP basis)	**-11.4**	**-14.5**	**-16.3**	-12.2	-8.5	-10.3	-7.0	-5.0	-13.6	-7.8	-2.9
Imports (BOP basis)	**-20.9**	**-18.4**	**-17.7**	-14.9	-4.0	-9.4	-5.7	-2.8	-18.0	-5.6	-1.4
Trade balance (US$bn, BOP basis)	**23.4**	**20.5**	**18.6**	19.3	18.2	17.7	16.4	16.7	81.8	68.9	62.5
Current account balance (% of GDP)	**27.8**	**23.5**	**23.0**	22.0	22.8	22.6	22.3	20.3	24.0	22.0	20.0
Fiscal Balance (% of GDP)									-1.0	-0.2	1.5
3 month SIBOR (%)	**1.01**	**0.82**	**1.14**	1.30	1.40	1.55	1.68	1.80	1.30	1.80	2.55
Exchange rate (SGD/USD)	**1.38**	**1.35**	**1.43**	1.42	1.45	1.47	1.49	1.50	1.42	1.50	1.46

Notes: Numbers in bold are actual values; others forecast. "Inventories" component contribution to GDP also includes statistical discrepancy. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015. Source: CEIC and Nomura Global Economics.

Thailand: We remain downbeat

In Asean we were most bearish on the economic outlook for Thailand in 2015 and this remains the case as we look to 2016. We reiterate our 2016 GDP growth forecast of 2.5%, a further slowdown from 2.7% in 2015, which still underperforms an already sharp structural decline in potential growth. The biggest drag on growth, we believe, will be from goods export growth, given slower China growth and limited external demand generally. However, there are also structural constraints such as a lack of skilled labour, limited investment in the manufacturing sector (which has stalled the upward movement of exports in the value chain) and diplomatic challenges under the current military regime, which render it difficult to renegotiate or participate in trade agreements.

Domestically, we believe political uncertainty, especially in H2 2016 (more below), will be a drag on private and public sector spending (see *Asia Insights - The economics of Thai politics II*, 20 June 2014), exacerbating ongoing problems of excess capacity in the manufacturing sector, falling farm incomes and still-high levels of household debt. In this context, recent fiscal stimulus measures are unlikely to prove effective (see *Asia Insights - Thailand: Still low fiscal stimulus*, 15 September 2015), while implementation of public infrastructure spending will continue to be hampered by the political environment.

A new constitution needs to be written by April 2016 and, provided it is approved in a public referendum, it should allow for elections in H1 2017 (Figure 50). The constitution drafting committee, which was selected in October 2015, has shown little inclination to reassess the controversial clauses such as allowing a non-elected prime minister and a majority-appointed senate, which were the reasons for the initial draft being rejected in September 2015 (see *Asia Insights - Thailand: A longer (and still bumpy) political ride ahead*, 1 July 2015). Our base case therefore remains that the current constitution is unlikely to be accepted in a public referendum, and that military rule will be prolonged for the foreseeable future until royal succession is completed. Political instability risks could rise if a rejection of the referendum is taken as a vote against military rule.

Fig. 50: Thailand: Political timeline

Timeline of the constitution drafting process, referendum and elections	
6-Sep-2015	NRC rejects the draft constitution
6-Oct-2015	21 charter drafters to rewrite constitution to be appointed; have 180 days to rewrite the constitution
29-Oct-2015	The date Yingluck and plantiff together set the dates for the examination of witnesses.
Apr-2016	New constitution draft will be ready
Apr-Jul 2016	Draft new constitution needs to be circulated to at least 80% of all eligible referendum voters.
Aug-Sep 2016	Referendum to be held 30-45 days after the circulation is completed
If the referendum is rejected	Likely back to the drawing board, with the junta trying to rewrite the constitution
If the referendum is held and accepted	CDC will draft organic or supplementary laws in August/September This would go to the NLA for approval in November/December 2016, followed by the Constitutional Court in **Once approved, elections would be held in H1 2017 and results announced 30 days later.**

Source: *Bangkok Post*; Nomura Global Economics.

In terms of monetary policy, we continue to forecast more rate cuts by the Bank of Thailand (BOT), a cumulative 50bp in H1 2016, with the first 25bp policy rate cut likely at the 3 February meeting, followed by another in Q2. Our GDP growth forecast for 2016 remains well below the BOT's 3.7%, which means that scope for central bank disappointment remains large.[5] The inflation backdrop is likely to remain supportive of further easing – even if our forecast of headline inflation rising to 0.7% y-o-y in Q1 (partly on base effects) materialises, this will still be well below the BOT's 1-4% headline inflation target.

[5] The National Economic and Social Development Board expects 2016 GDP growth of 3-4% while the Fiscal Policy Office forecasts 3.3-4.3%.

Fig. 51: Thailand: Details of the forecast

% y-o-y growth unless otherwise stated	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	2015	2016	2017
Real GDP (sa, % q-o-q, annualized)	**1.4**	**1.4**	**4.0**	1.0	3.9	1.3	1.3	2.8			
Real GDP	**3.0**	**2.8**	**2.9**	2.2	2.6	2.8	2.4	2.3	2.7	2.5	2.7
Private consumption	**2.4**	**1.6**	**1.7**	1.6	1.5	1.7	1.7	1.4	1.8	1.6	1.5
Public consumption	**3.3**	**3.8**	**1.0**	2.1	5.1	4.9	3.6	2.2	2.5	4.0	3.5
Gross fixed capital formation	**10.7**	**2.7**	**-1.2**	0.2	0.7	1.1	1.0	-0.1	2.9	0.7	1.6
Exports (goods & services)	**1.0**	**1.0**	**1.8**	-0.4	0.0	0.4	-0.8	-2.2	0.8	-0.7	1.2
Imports (goods & services)	**2.3**	**-0.4**	**-2.4**	-1.8	-1.5	-1.0	-1.4	-2.4	-0.6	-1.6	0.0
Contribution to GDP growth (% points)											
Domestic final sales	**3.9**	**2.2**	**0.8**	1.1	1.6	2.0	1.9	1.0	2.0	1.6	1.7
Inventories	**-0.1**	**-0.4**	**-1.1**	0.1	-0.1	-0.2	0.2	1.5	-0.4	0.4	0.1
Net trade (goods & services)	**-0.8**	**1.0**	**3.2**	0.9	1.0	1.0	0.4	-0.1	1.1	0.6	0.9
Exports (BOP basis)	**-4.3**	**-5.5**	**-4.7**	-6.0	-6.3	-5.5	-7.3	-7.5	-5.1	-6.7	1.0
Imports (BOP basis)	**-7.2**	**-10.1**	**-14.5**	-7.5	-2.0	-1.6	-2.5	-2.1	-9.9	-2.0	-1.5
Trade balance (US$bn, BOP basis)	**7.4**	**7.8**	**9.6**	7.9	5.0	5.7	6.8	4.9	32.8	22.3	27.0
Current account balance (US$bn)	**8.4**	**6.2**	**6.4**	5.1	4.2	0.9	2.8	7.2	26.0	15.1	14.7
Current account balance (% of GDP)	**8.1**	**6.1**	**6.7**	5.4	4.4	0.9	3.0	7.7	6.6	4.1	3.9
Fiscal balance (% of GDP, fiscal year basis)									**-2.4**	-2.3	-2.5
Consumer prices	**-0.5**	**-1.1**	**-1.1**	-0.7	0.7	1.1	1.4	1.5	-0.8	1.2	0.9
Unemployment rate (nsa, %)	**1.0**	**0.8**	**0.8**	0.9	1.1	1.1	1.1	1.1	0.9	1.1	1.2
Overnight repo rate (%)	**1.75**	**1.50**	**1.50**	1.50	1.25	1.00	1.00	1.00	1.50	1.00	1.00
Exchange rate (THB/USD)	**32.5**	**33.8**	**36.4**	36.1	36.6	37.1	37.6	38.0	36.1	38.0	38.0

Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 4 December 2015.
Source: CEIC and Nomura Global Economics.

Australia: Another sub-trend year

Risks run both ways, but we see more headwinds than tailwinds and expect continuing, moderately sub-trend growth, leading to a little more monetary policy easing in 2016.

Moderate though somewhat sub-trend growth

We characterise the broad policy backdrop as being fairly close to neutral. This reflects mildly restrictive fiscal policy (as Commonwealth and State governments continue to attempt to reduced budget deficit paths over time), an AUD now closer to fair value (no longer providing a major headwind to growth, but not yet a tailwind) and a continued easy monetary policy setting (albeit one operating with declining effectiveness, after years of low cash rates and with consumers holding relatively high debt levels).

We overlay the broad policy backdrop with some major themes:

- **Our cautious and below-consensus view on the Asian region has a meaningful impact on our Australian outlook.** Eight of Australia's top 10 export destinations lie in the region, comprising 70% of total merchandise exports in 2014-15, led (in order) by China, Japan and Korea. It is not just the growth slowdown in China – we are at the bottom of consensus forecasting 5.8% growth in 2016 – but also its changing composition (from investment to consumption) that is negative for Australia, impacting demand for bulk resources and commodity prices.
- **Closer to home, we expect to see further signs of a cooling housing sector as 2016 unfolds.** Finance commitments for construction purposes are displaying a negative trend and building approvals look to have peaked. We are confident that dwelling construction will make a smaller contribution to growth in 2016 than it did in 2015. House price gains are also moderating appreciably, and this may discourage consumers from running down savings, which the Reserve Bank of Australia (RBA) has assumed will support consumer spending in an environment of modest income growth.
- **El Nino is another risk to 2016 growth.** Agriculture represents only around 2% of GDP but a larger 13% of export values; an appreciable downturn in the farming sector could subtract a few tenths of a percentage point from GDP growth.
- **On the upside, we will be watching to see whether improved business sentiment**, following Malcolm Turnbull's ascension as prime minister, translates into stronger non-mining investment. Weakness here has been a major contributor to consistent RBA growth downgrades over the past two years. The RBA expects mining investment to continue to unwind over the next two years, detracting from growth, as existing projects are completed while there are few new projects in the pipeline.
- **A lower AUD is aiding in some transition from resource to service-sector activity.** The total value of service exports rose 8%, to around AUD64bn over the past 12 months, and inbound tourist spending grew by a solid 10% in 2014-15, to AUD33bn (led by AUD7bn of spending from China). However, service exports represent only 20% of total export values, whereas non-rural goods exports make up 62%, led by iron ore and coal. We judge that service-sector exports will not be able to take up all the slack from weak resource export values, particularly given our expectation that key bulk commodity prices will remain around current low levels, reflecting slowing growth in China and rising supply, and thus again averaging lower next year than in 2015.
- **One of the themes we have been exploring is the changing sectoral composition of growth in Australia.** In particular, weakening capital-intensive mining has given way to stronger growth in labour-intensive service industries, including education, healthcare and tourism. This has helped to "square the circle" between only moderate GDP growth and relatively strong employment growth. However, we contend that the Australian data need to be interpreted sensitively and the local economy is not as strong as the headline data suggest. We explore this in Box 10: Less robust than it seems.

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Contained inflation

Q3 CPI inflation data were surprisingly soft. Regulated utility prices fell and weaker rises in rents and new dwelling purchase costs were notable, reflecting increased housing supply and a cooling housing market. Food prices also rose by a very modest 0.1% q-o-q, likely influenced by a price war between Australia's two largest retailers. Fierce retail competition is also evident in the modest 0.9% y-o-y rise in the retail trade deflator, with retailers effectively shielding consumers from the impact of a lower AUD. Overall, despite a lower AUD over the past two to three years, inflation has remained quiescent because of the decline in oil prices and the absence of domestic pricing power. Hourly pay rates, excluding bonuses, rose by a modest 0.6% in Q3 and by 2.3% y-o-y, with private sector wages up only 2.1% y-o-y, keeping wage growth around 20-year lows. Moderate growth, excess spare capacity in the labour market and fierce retail competition should keep inflation contained, even in the presence of a lower AUD. We also remain mindful of the impact of global excess capacity and the structural impact of technology in assisting price discovery.

Policy outlook

The RBA has indicated that low inflation provides "scope" to lower the cash rate, but does not believe that recent activity data suggest that the economy currently needs it (see *Australia: Cash rate again kept at 2%*, 1 December 2015). We believe it is appropriate for the market to price in the risk of a rate cut and we continue to forecast a lower cash rate in 2016, while flagging the risk that this could come later than our current February call. The RBA's language has been relatively upbeat of late, but we view this as a deliberate tilt aimed at helping restore animal spirits. Over the past few months, Asian growth has generally underwhelmed; AUD has risen a little despite the further slide in steel and iron ore prices; commercial bank lending rates have risen on average by around 12bp; and the housing sector is cooling. We view the 0.9% q-o-q bounce back in Q3 GDP as largely a mechanical and weather-affected payback after a weak Q2. Our expectation for continued sub-trend growth and benign inflation supports further policy easing.

The main downside risks to our outlook are a major growth setback in China and financial market dislocation. Improved animal spirits, or a decision by the federal government to embark on infrastructure spending initiatives, are upside risks to growth. Increased infrastructure spending would be a welcome development, though we doubt this could be initiated within the next 12 months.

Fig. 52: Details of the forecast

%q-o-q	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	2014	2015	2016	2017
Real GDP (% y-o-y)	2.1	1.9	2.5	2.6	2.4	2.7	2.3	2.4	2.2	2.3	2.6	2.3	2.4	2.4
Real GDP	0.9	0.3	0.9	0.5	0.7	0.6	0.5	0.6	0.6	0.6	2.6	2.3	2.4	2.4
Personal consumption	0.5	0.6	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	2.7	2.5	2.3	2.1
Private investment	-1.1	-0.7	-2.9	-0.4	0.0	0.5	0.7	1.0	1.0	1.0	-1.9	-4.2	-0.9	3.9
Business investment	-2.8	-1.0	-4.1	-1.1	-0.3	0.4	0.6	1.1	1.1	1.1	-4.2	-7.8	-2.7	3.9
Dwelling investment	4.6	0.4	0.9	1.5	1.1	1.0	1.0	1.0	1.0	1.0	7.4	8.6	4.3	3.9
Government expenditures	0.7	1.8	-1.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.0	1.2	1.1	0.9
Exports	3.7	-3.3	4.6	1.4	2.9	1.9	1.5	1.5	1.6	1.8	6.7	6.2	8.1	6.9
Imports	3.0	0.1	-2.4	0.3	0.6	0.8	1.0	1.0	1.0	1.0	-1.6	0.8	0.9	3.9
Contributions to q-o-q GDP:														
Domestic final sales	0.2	0.6	-0.5	0.2	0.3	0.4	0.4	0.5	0.5	0.5	0.9	0.6	1.1	2.1
Inventories	0.5	0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.8	0.1	-0.1
Net trade	0.2	-0.7	1.5	0.2	0.4	0.2	0.1	0.1	0.1	0.1	1.4	0.8	1.2	0.4
Unemployment rate	6.2	6.0	6.2	6.2	6.2	6.2	6.2	6.1	6.1	5.9	6.1	6.2	6.2	5.8
Employment, 000	71	62	72	47	47	47	54	54	54	72	31	63	51	68
Consumer prices	1.3	1.5	1.5	1.7	1.9	1.9	2.2	2.2	2.3	2.1	2.5	1.5	2.1	2.3
Trimmed mean	2.5	2.4	2.2	2.2	2.0	2.0	2.2	2.2	2.3	2.4	2.6	2.3	2.1	2.4
Weighted median	2.3	2.2	2.1	2.2	2.1	2.2	2.5	2.5	2.5	2.5	2.5	2.2	2.3	2.5
Fiscal balance (% GDP)											-3.1	-4.0	-3.9	-3.1
Current account balance (% GDP)											-2.8	-4.1	-4.0	-3.3
RBA cash rate target	2.25	2.00	2.00	2.00	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.00	1.75	2.25
3-month bank bill	2.21	2.14	2.19	2.00	1.80	1.80	1.80	1.90	1.90	2.10	2.78	2.00	1.90	2.10
2-year government bond	1.72	2.01	1.81	2.00	2.00	2.05	2.10	2.15	2.25	2.30	2.19	2.00	2.15	2.50
5-year government bond	1.84	2.32	2.06	2.25	2.30	2.45	2.60	2.70	2.80	2.90	2.27	2.25	2.70	3.10
10-year government bond	2.32	3.01	2.61	2.80	2.90	3.00	3.10	3.20	3.30	3.40	2.81	2.80	3.20	3.60
AUD/USD	0.76	0.77	0.70	0.70	0.69	0.68	0.67	0.67	0.68	0.68	0.82	0.70	0.67	0.69

Notes: Quarterly real GDP and its contributions are seasonally adjusted. Interest rate and exchange rate forecasts are end of period. Numbers in bond are actual values. Table reflects data available as of 4 December 2015. Source: Australian Bureau of Statistics, Reserve Bank of Australia, Nomura Global Economics

Box 10: Less robust than it seems

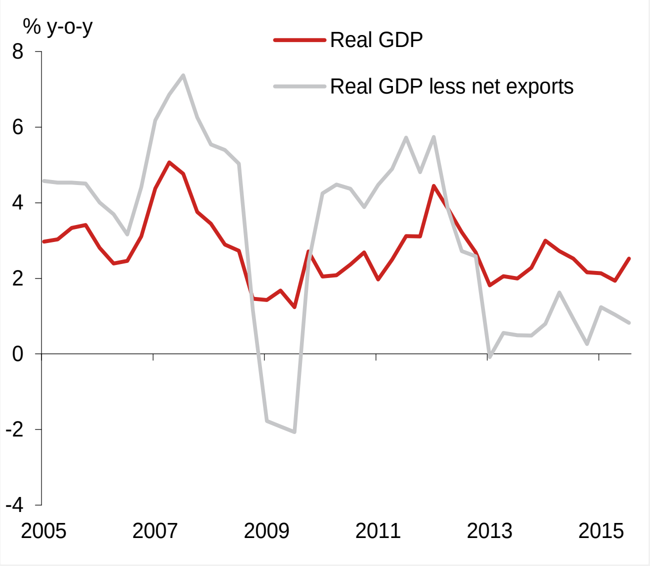
Recent RBA and media commentary has been relatively upbeat, highlighting signs of economic strength. While noting some better recent activity releases, we contend that the data need to be interpreted sensitively. Some large structural transitions are underway which, in our view, is making the economy weaker in underlying terms than some of the headline data suggest.

Real GDP has been appreciably boosted by net exports over the past two years (Figure 53), while domestic demand has been quite weak. This reflects, in part, an attempt by bulk commodity exporters to offset lower prices with higher volumes and we note, of course, that real GDP data only captures the latter. In addition, an appreciable portion of the income earned from these businesses flows directly to the offshore owners of these assets (including in LNG). Modest domestic demand and declining business investment have also slowed capital import volumes, further boosting real GDP. Allowing for price effects, we note that nominal GDP growth is currently very weak relative to real GDP growth. Figure 54 illustrates that this is historically quite unusual and reflects the significant decline in the terms of trade over recent years, driven largely by lower bulk commodity prices.

Much of Australia's real GDP growth in recent years has been driven simply by population growth. This has slowed over the past year or so, due to weaker net immigration (and likely reflecting fewer perceived economic opportunities, in our view, rather than any change in government policy) but has still been appreciable, at 1.4% y-o-y. However, real net national disposable income per capita is down 2.4% over the past 12 months, and these data suggest that living standards in Australia have in fact been declining for three years.

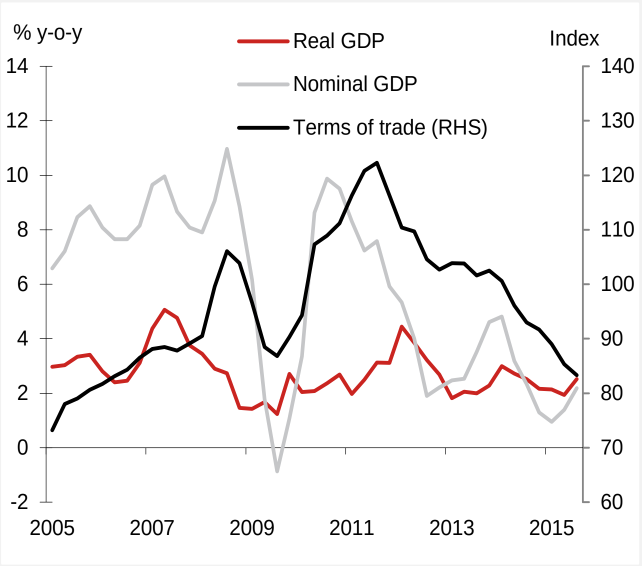
Turning to the labour market, we note that while trend employment growth has been strong, at 2.3% y-o-y, this has been disproportionately driven by female and part-time employment growth, likely reflecting growth in service sectors (including education, public administration, healthcare and social services) versus relative weakness in sectors such as mining and manufacturing. While it is (obviously) better to have employment growth than not, we note that consequent income growth across the nation has been less strong than headline employment growth data might imply, and this will likely constrain the pace of future private consumption growth. Corroborating evidence can be found in the different wage measures. While hourly rates of pay have risen by 2.3% y-o-y, average weekly earnings – which measure earnings per employee and so captures compositional shifts in employment by sector – have only risen by 1.2% y-o-y. Meanwhile, other wage data suggest that growth in bonuses has completely stalled.

Fig. 53: Real GDP and GDP less net exports



Source: ABS, Nomura

Fig. 54: GDP and the terms of trade



Source: ABS, Nomura

Asia FX: Harvesting the rough seas

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In the year ahead, we expect broad Asia FX depreciation (versus USD). Based on our end-2016 forecasts, we see the highest total returns on long USD/KRW (7.0%), long USD/SGD (5.9%), and short USD/INR (5.6%) positions. We forecast USD/KRW at 1250 (FX forward at 1163), USD/SGD at 1.50 (FX forward at 1.41) and USD/INR at 67.4 (FX forward at 71.2), respectively (Appendix A).

Here, we elaborate on both the global and local factors that shape our views and detail the rationales for our Asia FX recommendations for 2016. These include: 1) **Downside risks to China's economy and RMB depreciation**; 2) **Fed rate hikes and USD strength in G3**; 3) **Asia monetary policy loosening**; 4) **Politics**, with numerous presidential and parliamentary elections in 2016, as well as **policy concerns** given key credible central bank governors stepping down; and 5) **Nomura's assumption of low commodity prices**, but pressures on food prices from **El Niño**.

Taking into account the major global themes and local idiosyncratic factors, we recommend the following trades into 2016:

- **Long USD/KRW** (target spot at 1230, total return of 5.6% by Q2 2016).
- **Long USD/TWD** (target spot at 33.9, total return of 3.5% by Q2 2016).

KRW and **TWD** are the most sensitive currencies in Asia to China macro and RMB depreciation risks given the strong economic (Figure 55) and financial channel linkages (Figure 56). Fed rate hikes and risks of policy divergence – with two rate cuts expected from the BOK (-50bp) and one from Taiwan's CBC (-12.5bp) by mid-2016 – should also weigh on KRW and TWD. Indeed, from a global policy perspective, the divergence in Fed, ECB and BOJ monetary policy is likely to add to the strengthening of USD while pressuring KRW, TWD and broad Asia FX. Nomura's FX strategy team forecasts EUR/USD to fall to parity in Q2 2016 and JPY to depreciate (versus USD) to 128 in Q2 2016.

Locally, in **South Korea**, the main risks are the pro-growth stance (supporting Nomura's view of rate cuts) ahead of the parliamentary election (13 April), the government implementing capital outflow policies (see Box 6: Forthcoming measures to encourage overseas portfolio investments) and market concerns over the cancellation of shipbuilding orders and the resulting FX hedging unwinds from local shipping companies. In **Taiwan**, the presidential and parliamentary elections (both on 16 January) could negatively affect TWD. We also believe that the authorities are likely to maintain a bias to keep TWD weak.

- **Short USD/INR** (target spot at 67.2, total return of 2.9% by Q2 2016).
- **Short USD/PHP** (target spot at 47.6, total return of 0.4% by Q2 2016).

On **INR**, the market's realisation that major reforms will remain slow should not alter expectations of numerous positive local developments, including the strengthening cyclical story driven by domestic demand. India's FX vulnerability has fallen substantially, in our view, given the shift to a basic balance surplus, the increase in monetary policy credibility and the significant accumulation of FX reserves (and FX forward book adjustments) since 2014. In the **Philippines**, although we do not expect any significant total return from a short USD/PHP position through H1 2016, the position should reduce FX volatility from a long USD portfolio. Our long PHP rationale extends from relatively strong domestic demand-driven growth, a credible monetary policy, and strong remittances and business process outsourcing (BPO) inflows. As with INR, the relatively low sensitivity of PHP with the DXY, EUR and JPY and direct links with China (compared with KRW and TWD) also support our view of long INR and PHP as relative value trades.

- **Short SGD/MYR** (target spot USD/SGD at 1.45 and spot USD/MYR at 4.23, total return of 3.4% by Q1 16).

Our bias to be **short SGD/MYR** is based on SGD holding the highest sensitivity to DXY, EUR and JPY in the region. Singapore's growth outlook also remains weak, inflation remains below target, while the MAS has eased FX policy twice in 2015 – and there is some risk, though not our base case, of further easing in the next 12 months. The impact from China's macro slowdown and FX depreciation also looks to be more significant for SGD than MYR, but Malaysia's linkages are still relatively strong. That said, we believe there are numerous factors that could cause MYR to outperform SGD in the next few months. These include the significant reduction in foreign positioning in MGS (namely BNM bills) from Fed hike fears, reduced political concerns and diminished vulnerability to the fall in commodity prices. Local political risks are likely to fade in the year ahead, in our view, while stable oil prices should also help reduce the negativity on Malaysia that has been prevalent over the last year and a half. We also believe BNM has numerous policy options, as does the government, if MYR was to face significant depreciation pressure again.

- **Long USD/CNH** (target spot at 6.65, total return of 1.4% by Q2 16).
- **Long 12M USD/HKD** (target spot at 7.80, total return of 0.7% by Q2 16).

While we do not expect **short CNH** and **HKD positions** (vs. USD) to generate high total returns in 2016, we believe they will be relatively high Sharpe ratio trades, with more consistent FX depreciation on CNH and asymmetric depreciation risk on HKD. We detail below the key rationales for our CNH depreciation view, but concerns include China's weaker macroeconomic outlook and more monetary policy easing when the Fed is hiking, a focus on the government's multi-market intervention and RMB overvaluation. Over the medium term, the main concern for RMB is the private sector moving money into foreign assets. On **HKD**, we do not expect a peg adjustment in 2016, but there are a number of negative factors that could prompt both spot and HKD forwards to trade higher through the year, including downside China economic risks and RMB depreciation, Fed hikes, concerns over the build-up of local private-sector debt and HKD overvaluation (see Box 3: Thinking outside the box).

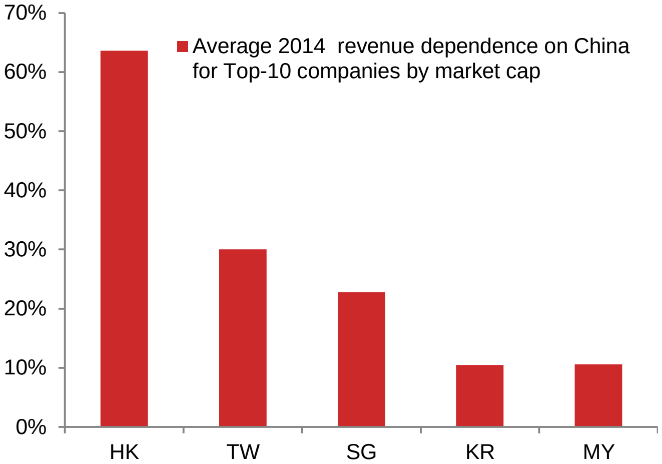
In the **rest of the region**, we forecast total returns of 0.5% on short USD/IDR and 2.8% on long USD/THB positions by Q2 2016. Nomura Economics has recently turned more positive on **Indonesia's** growth outlook from both a fiscal and monetary policy stimulus, as well as the series of small reform measures which are beginning to add up. That said, we believe there will be some challenges to the overall balance of flow given the current account deficit and the financing of this, against an external backdrop of Fed hikes and weakening China growth. We also expect THB depreciation (versus USD) given the macro backdrop, rate cuts and continued political concerns.

Fig. 55: Trade weights with China

Proportion of trade with China (2014)	
HKD	52.2%
KRW	34.3%
PHP	25.2%
THB	22.3%
MYR	22.2%
TWD	22.1%
IDR	18.6%
INR	16.4%
SGD	16.4%

Source: Bloomberg, Nomura.

Fig. 56: Corporate earnings dependence on China



Source: Bloomberg, Nomura.

Main themes for Asia FX in 2016

1) China macro and FX depreciation risk

Near-term hopes of a cyclical improvement in China are falling given the mixed bag of recent economic data. There has been some improvement in the Caixin PMI, home prices, motor vehicle sales and M2 growth, but the official PMI, new loans and total social financing (TSF), exports and imports, and industrial production data have all disappointed. Indeed, if the stabilisation of the economy that some forecast in coming months fails to materialise (while others expect an actual uptick), the risk is that there is more monetary and fiscal stimulus emerging in the near term. Currently, Nomura Economics continues to highlight downside risks to GDP growth of 5.8% in 2016 (Consensus: 6.5%) because of the weakness in financial services and slowing investment in property and manufacturing. The slowdown of the economy in 2016 will likely sustain concerns over credit risks and local financial markets, leading to the PBoC to cutting the RRR by 200bp and benchmark rates by 50bp in 2016 (Nomura forecasts).

Indeed, we continue to believe that there will be a medium-term structural capital outflow from the private sector, in part because of weakening growth, but also because of our expectation of fiscal and monetary easing and our view that RMB is around 6.4% overvalued (Figure 57). We consider the structural outflow to be foreign-asset diversification, given the opening of China’s capital account. This may be similar to Japan’s capital account liberalisation in the 1980s, which led to a significant acceleration of investment overseas.

Fig. 57: Asia FX valuations

(-ve = undervalued, +ve = overvalued)	CNY	HKD	INR	IDR	KRW	MYR	PHP	SGD	TWD	THB	Average
1) FEER	-4.6%	4.4%	-10.0%	4.0%	-5.8%	-3.6%	-12.6%	-23.6%	-53.5%	-5.9%	-11.1%
2) PPP (CPI-based, dev from 10y avg)	11.6%	11.8%	5.6%	-13.4%	-3.2%	-18.7%	5.1%	-0.3%	-5.5%	-6.2%	-1.3%
3) Prod adj (avg dev from 10y and 5y avg)	-0.2%	9.9%	-2.2%	-6.7%	3.3%	0.2%	9.9%	7.8%	-1.8%	4.6%	2.5%
4) REER (deviation from 10y avg)	24.7%	15.1%	9.4%	-5.6%	1.6%	-13.2%	14.6%	6.7%	-0.6%	1.7%	5.4%
Average of 1, 2, 3	*2.3%*	*8.7%*	*-2.2%*	*-5.4%*	*-1.9%*	*-7.3%*	*0.8%*	*-5.4%*	*-20.3%*	*-2.5%*	*-3.3%*
Average of 1,2, 4	*10.6%*	*10.4%*	*1.7%*	*-5.0%*	*-2.5%*	*-11.8%*	*2.4%*	*-5.7%*	*-19.9%*	*-3.5%*	*-2.3%*
Overall average	**6.4%**	**9.5%**	**-0.3%**	**-5.2%**	**-2.2%**	**-9.6%**	**1.6%**	**-5.5%**	**-20.1%**	**-3.0%**	**-2.8%**

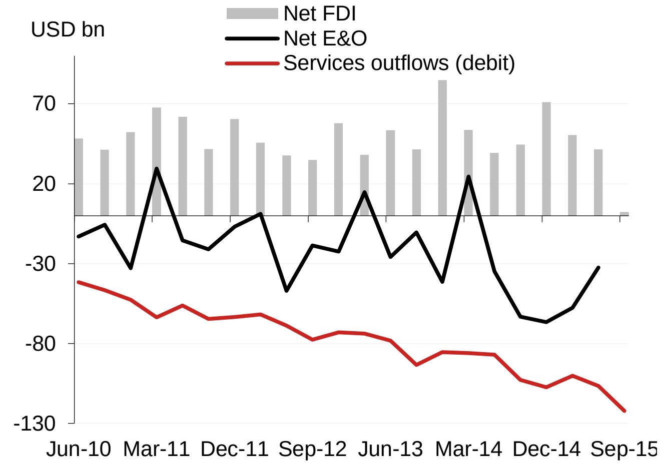
Source: CEIC, Bloomberg, Nomura. Note: REER s are as of Oct-15 and uses BIS REER for all currencies except INR which uses the RBI 36-country REER. EU measures are weighted average of France, Germany, Italy, Spain and the Netherlands.

We believe that, in the case of China, the continued liberalisation of the capital account as well as local vulnerabilities, US-China monetary policy divergence, the government’s anti-corruption drive and changes in the FX regime will lead to an increase in private-sector capital outflows that could largely offset the basic balance surplus. This view is reflected in the significant gap between China’s net international investment position (IIP) and that of the public sector (FX reserves). As of Q2 2015, this gap was USD2.2trn (20.9% of GDP) with FX reserves at USD3.7trn (34.5% of GDP) and net IIP at USD1.5trn (13.7 % of GDP), indicating a dearth of China private resident investments overseas.

In addition, an acceleration in capital outflows from local retail deposits is a significant concern. As of September 2015, local RMB deposits were equivalent to USD17.5trn and statistics from the China Household Financial Survey Center show that the wealthiest 10% of households owned 35% of bank savings deposits (equal to around USD6.1trn equivalent, or 1.7x FX reserves). According to the fourth *China Private Wealth Report* from China Merchants Bank and Bain & Co (published 26 May 2015; i.e., before the 11 August FX regime change), nearly 40% of high net worth individuals (HNWIs) surveyed and almost 60% of ultra-HNWIs surveyed indicated that they had overseas investments – a sizable jump from 19% and 33%, respectively, in 2011. Importantly, nearly half of the HNWIs said they planned to increase their overseas investments in the next year or two.

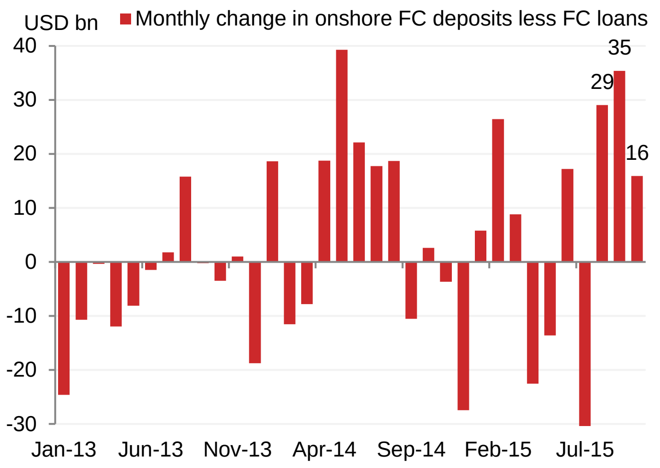
Hard-landing concerns aside, we believe there is strong demand for diversification from Chinese residents into overseas assets. There are numerous channels beyond those captured in the errors and omissions of the BoP (-USD220bn in the 12 months to Q2 2015). These include both FDI (overseas investment) and services (tourism and financial), which have also been highlighted by official news agencies such as *Xinhua* and *China Business News*. Indeed, over the 12 months to Q3 2015, the services deficit ballooned to USD202bn from USD19bn five years ago (note Nomura Economics forecasts a 2016 trade surplus of 6.8% of GDP and the current account surplus at only 3.2% of GDP). China’s net FDI surplus remains strong, but looks to have peaked in 2014 as FDI outflows continue to increase to new record levels (at -USD31.4bn in Q3 2015, Figure 58). The other is the upcoming Qualified Domestic Individual Investor (QDII2) programme, which as it stands will allow individuals with at least RMB1m of net financial assets (average daily balance of net financial assets in the past three months) to invest offshore.

Fig. 58: China: Net FDI and capital outflows



Source: CEIC, Nomura.

Fig. 59: China: Overall foreign currency deposits (less FC loans)



Source: CEIC, Nomura.

Potential for further capital inflows

There are some structural inflows, including the trade surplus and net FDI, where Nomura forecasts a trade surplus of USD733.4bn in 2016 (USD616.3bn in 2015). However, the trade surplus is expected to be driven by weak imports and we see a significant risk that a large proportion of export proceeds are not remitted and held in foreign currency. Indeed, as an indicator of the desire to hold foreign currency, foreign currency deposits (less foreign currency loans) in the local banking system rose by USD80.3bn in the three months to October 2015 (Figure 59). We note that, even with China's trade and net FDI surplus averaging USD60.7bn per month over the last 12 months to September 2015, FX reserves (adjusted for FX valuation and coupon effects) have fallen in nine of the last 12 months. We also see limited immediate capital inflows from RMB's inclusion in the IMF's SDR basket, because it does not take place until 1 October 2016. SDR inclusion is essentially just a potential claim on the freely usable currencies of IMF members, and any transactions would be done at the central bank level. In addition, the size of the SDR is relatively small at around USD285bn (equivalent as of 30 November 2015) and with RMB assigned a 10.92% weighting, this would only imply a USD31.1bn reallocation.

That said, the indirect positive effects of SDR basket inclusion could be significant over the longer term for a number of reasons, including foreign entities being broadly "underinvested" in RMB assets. As of September 2015, these entities held RMB3.0trn (USD464bn) in RMB assets (debt, equities and deposits) in onshore markets. This constitutes only 4.0% of global foreign reserves of USD11.5trn (Q2 2015 IMF COFER data) and is significantly below China's 17% share of world GDP. Indeed, even though there are numerous countries already holding RMB in their FX reserves, a joint report by Central Banking and HSBC (April 2015) highlights that RMB will likely rise to 10% of global FX reserves by the end of 2025 from a forecast 2.9% at end-2015. Taking the USD7.76trn of non-China global FX reserves as of Q2 2015, this would imply an increase in allocation into RMB of around USD551bn over this 10-year period. However, we believe that, with the challenges in 2016, the potential inflows over the next year will be limited to perhaps around USD40bn.

Another channel of inflows will be through global real money asset allocation, with global AUM at end-2014 of around USD69trn (11%, or USD7.7trn invested in EM). Indeed, the main near-term focus is on potential MSCI inclusion, where MSCI's proposal is for a 5% partial inclusion of China A-shares into the MSCI EM Index. Some market participants expect an announcement on MSCI inclusion before June 2016 (*Bloomberg*). Although the partial inclusion would be small, and likely to translate into a 1.3% index weighting in the MSCI EM Index and 4.2% in the MSCI China index, we view it as a significant positive step towards greater capital inflows over the medium to long term. With around USD1.7trn (*Wall Street Journal*) of active and passive funds tracking the MSCI EM Index, a 5% partial A-share inclusion could lead initially to around USD22bn flowing into A-shares.

Overall, we continue to believe the capital flow backdrop in China will remain challenging in 2016 because of the continued growth slowdown, macroeconomic risks, policy easing, FX overvaluation and structural private sector outflows. We forecast USD/CNH at 6.65 (Consensus: 6.48; FX forwards: 6.56) in Q2 and 6.80 (Consensus: 6.55; FX forwards: 6.64) in Q4 2016.

For Asia FX, our view of a weaker RMB adds to depreciation risk in the region. Specifically, through trade and financial channels, our analysis suggests TWD and KRW are the most vulnerable in Northeast Asia, while SGD and MYR look the most vulnerable in Southeast Asia because of their basket regimes. Indeed, these four currencies top our sensitivity analysis of Asia FX's reaction to a surprise move in CNY. These were also the currencies that saw the largest depreciation in the region to the surprise USD/RMB move on 11 August 2015.

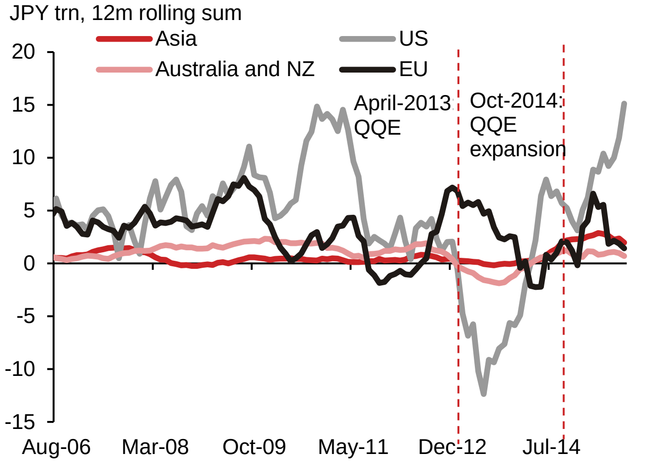
2) Fed rate hikes and USD strength

Fed rate hikes and global policy divergences will also be factors affecting Asian FX in 2016. Nomura forecasts the Fed's tightening cycle to be gradual, with the fed funds rate forecast at 88bp by the end of December 2016 (after three 25bp hikes, starting from December 2015). This is close to the December 16 fed funds futures market pricing of 85bp. However, Fed policy is likely to further diverge from both ECB and BOJ policy, both of which have easing biases. The ECB may have disappointed on 3 December given elevated market expectations, but Nomura Economics still believes that the ECB will have to do more given downside risks to euro area inflation. We also expect additional monetary easing by the BOJ in April 2016. This is the major reason for our view that EUR/USD will trade towards parity in Q2 2016, while USD/JPY should rise to around 128 over the same period. We believe this, on top of RMB depreciation, will add to the upside pressure on USD/Asia and mainly for the more DXY-sensitive currencies, including SGD, KRW, TWD and THB.

Markets may expect the ECB and BOJ balance-sheet expansion – totalling EUR720bn (around USD784bn) and JPY80trn (around USD653.6bn) a year, respectively – to offset the impact from the Fed's policy normalisation. However, data released since the various QE policies have only shown a significant pick up in gross portfolio inflows into the US and DM compared with EM/Asia.

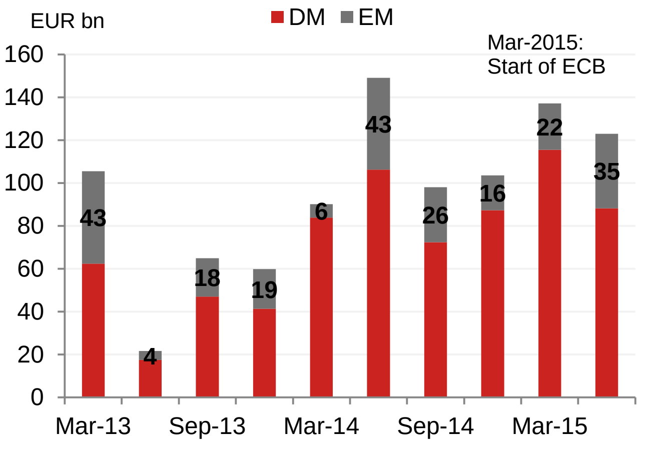
In the 12 months since Japan's QQE began in April 2013, there was close to zero gross portfolio inflows into Asia. However, since QQE's expansion in October 2014, gross portfolio inflows into Asia have totalled JPY2trn (around USD16bn) to September 2015. This compares with JPY15.1trn (around USD123bn) of gross portfolio inflows into the US in the 12 months to September 2015 – a big turn around from the JPY12.4trn outflow in June 2013 (12-month rolling, Figure 60).

Fig. 60: Japan's gross portfolio outflows to different regions



Source: CEIC, Nomura.

Fig. 61: Euro area gross portfolio outflows to DM/EM



Source: ECB, Nomura.

From the euro area, post-ECB QE in March 2015, there have also been limited signs of any significant pick-up in gross portfolio outflows to EM. These totalled EUR34.7bn in Q2 2015 compared with EUR88.2bn into DM over the same period. This ratio of investment into EM versus DM from euro area investors was 39% in Q2 2015 – a pick-up from the previous two quarters, but only slightly above the average 33% since 2013 (Figure 61).

3) Monetary policy loosening/pro-growth bias in Asia

In Asia, we believe numerous central banks will loosen policy soon after a Fed lift-off (expected in December). In September 2015, when Fed lift-off expectations were pushed out to March 2016 (from December 2015), we noted that several Asian central banks eased policy in September/October, including the CBC (24 September and surprising consensus), RBI (29 September and surprising consensus by the magnitude), MAS (14 October) and the PBoC (23 October). While policy in Asia has been broadly stable since the repricing of Fed rate hike expectations back to December 2015 (after the more hawkish than expected 28 October FOMC meeting), Nomura Economics expects further rate cuts into 2016 from the BOK by 50bp (starting in February 2016), CBC by 12.5bp (on 17 December 2015), BI by 50bp (before end-Q1 2016), BOT by 50bp (before end-Q2), and the PBoC (by a further 50bp, starting from Q2).

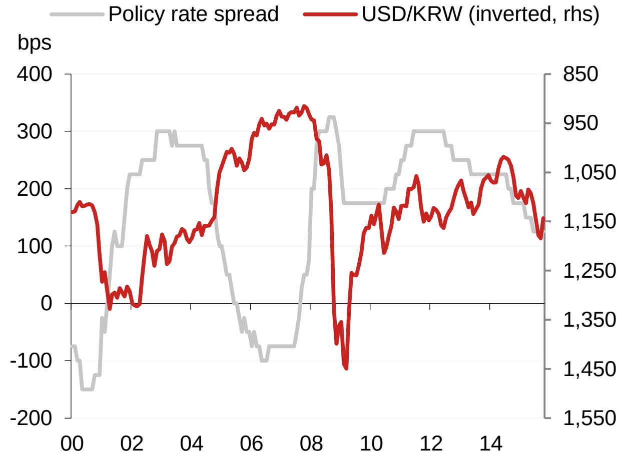
Overall, in most of Asia we believe there is a bias to ease monetary policy despite the normalisation in US Fed policy – and, in our opinion, this pro-growth bias could risk leading to some depreciation in KRW, TWD, RMB, THB and IDR (Figures 62 and 63).

Fig. 62: Asia's monetary policy divergence

Policy rates	Current	End-2016 (expected)	Change (bps)
India	6.75	6.75	0
Korea	1.50	1.00	-50
Phil.	4.0	4.5	50
Malaysia	3.25	3.25	0
Taiwan	1.75	1.63	-12
Indonesia	7.5	7.0	-50
Thailand	1.50	1.00	-50
China	4.35	3.85	-50
USA	0.125	0.875	75

Source: Bloomberg, Nomura.

Fig. 63: USD/KRW and policy rate differential



Source: CEIC, Nomura. Note: Policy rate spread is Korea base rate minus US Fed funds target

4) Political and policy risks

In 2016, there will be several political and policy-related events that could be significant for Asia FX. The first is the 16 January Taiwan presidential[6] and legislature elections, where numerous polls continue to show the DPP's Tsai Ing-wen leading with 45.2-47.1% of the vote over the KMT's Eric Chu (with 16.4-28% of votes).[7] We believe the market is already broadly of the view that Tsai Ing-wen will be the next president (term starts on 20 May 2016) and that policy towards China may be less open. However, focus will also be on the legislative elections, held on the same day,[8] where, if the DPP gains a strong two-thirds majority,[9] potential market concerns of an anti-China stance could increase given the DPP's ability to amend the constitution.

The run-up to South Korea's parliamentary elections (13 April) will also gain market attention, where there is a risk of an emergence of pro-growth policies (rate cuts and a weaker KRW) given the weak growth backdrop, low inflation and recent protests over labour market reforms. If the ruling party wins (Nomura's base case), we expect little change in the government's policy stance, but if the opposition party wins, policy could shift to focus more on equality, rather than growth.

[6] Polling of the presidential election is from 8am to 4pm with the result announced on the same day.

[7] TVBS survey reported by *Bloomberg* (19 November 2015); Taiwan Indicators Survey Research reported by *Taipei Times* (30 October 2015); Cross-Strait Policy Association survey reported by *Taipei Times* (19 October 2015).

[8] New legislators take office 1 February 2016.

[9] KMT currently holds 64 of the 113 seats in the legislature.

The 9 May presidential election in the Philippines is likely to be a tight race. Senator Grace Poe remains a popular candidate; she is perceived to be anti-corruption and topped a *Bloomberg* poll of analysts and bankers in June. Mar Roxas, being the administration's candidate, should have support from the government and benefit from ongoing accelerated fiscal spending and strong growth. The less positive result for markets would be a win for current Vice President Binay, as he is viewed as having a poor anti-corruption track record or Rodrigo Duterte who has a poor human rights track record. If Poe's appeal against her disqualification proves unsuccessful, this could favour Roxas – an outcome that would, in our opinion, have a limited impact on the market given the prospects of policy continuity.

In Thailand, the junta-led government is expected to remain in place at least until elections in 2017 following the rejection of the draft constitution by the National Reform Council on 6 September 2015. A re-draft of the constitution will be voted on in a referendum (possibly around August-September 2016), but the risk is this will be rejected in the public referendum given contentious issues: 1) the inclusion of the National Strategic Reform Committee, which could seize executive and legislative power during a period of crisis; 2) membership to the House of Representatives and Senate; and 3) prime ministerial power.

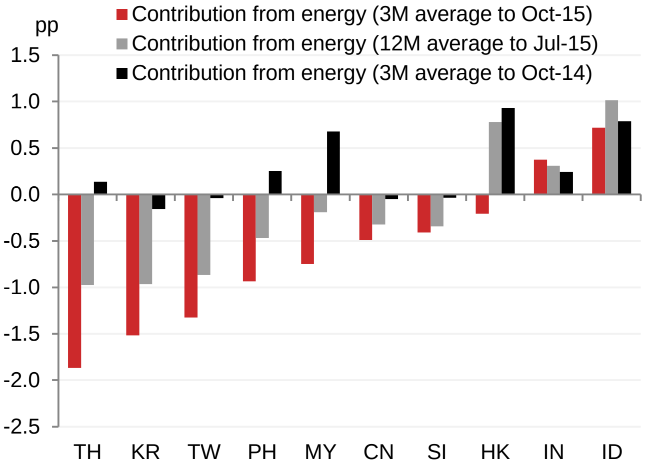
Lastly, there may be some concerns over monetary/FX policy, with the terms of Malaysia's BNM Governor Tan Sri Dr Zeti Akhtar Aziz and RBI Governor Raghuram Rajan ending in May and September, respectively. We note there is a possibility that Governor Rajan's term is extended by two years, while Governor Zeti has given strong indications that she will step down. Both central bank governors are highly respected and their replacements will be watched closely to see if there will be any less independence or a shift in monetary/financial market policies (Figure 64).

Fig. 64: Asia political calendar

Country	Date	Event
Taiwan	16-Jan-16	Presidential and legislative elections
Korea	13-Apr-16	Legislative elections
Malaysia	13-Apr-16	BNM Gov. Zeti term ends
Thailand	Apr-16	Draft of new constitution
Philippines	9-May-16	National elections
India	May-16	Kerala, West Bengal, Tamil Nadu, Assam state elections
India	Jun-16	Puducherry state elections
India	3-Sep-16	RBI Gov. Rajan term ends
Malaysia	latest 20-Sep-16	Sarawak elections
Thailand	Aug-Sep 16	Referendum

Source: Nomura.

Fig. 65: Drag on Asia inflation from energy prices



Source: CEIC, Nomura.

5) Commodity prices

Commodity prices remain an important driver of Asia FX. Since mid-2014, the collapse in commodity prices has led to lower inflation in Asia (Figure 65) and broad improvements in Asia's terms of trade (Figure 66). However, with Nomura's assumption that commodity prices are likely to remain relatively stable in 2016 at around current low levels, the impact on Asia's external balances and FX should be limited despite some upside pressure on inflation because of base effects and a possible rise in food prices.

However, Asia remains susceptible to commodity price developments, and if commodity/oil prices were to rise, there could be a reversal of the benefits to the terms of trade (except Malaysia) and lower inflation broadly in the region. Note that the IMF, World Bank and *Bloomberg* consensus continue to forecast oil prices rising to average USD54.7bbl in 2016 (a ~26% rise from current levels), which, combined with rising food prices due to El Niño, could raise political/social/policy vulnerabilities in the region (see *Anchor Report: The next food price surge* , 27 August 2015). Although higher food prices are more a risk for global emerging markets outside Asia, our assessment of social/political, inflation/monetary policy and capital flight risks from a food price shock suggests Thailand, Indonesia, Malaysia, India and China are more vulnerable in Asia.

Fig. 66: Impact of commodities on Asia trade

figures in USD mn	China	India	Indonesia	Malaysia	Philippines	Korea	Taiwan	Thailand	Total
Net oil imports H1 2014	118,569	51,413	13,611	522	3,052	38,575	14,673	17,388	**257,802**
Net oil imports H1 2015	67,435	30,817	7,533	(1,004)	1,968	20,266	7,424	10,798	**145,237**
Net nonoil commod imports H1 2014	165,072	15,903	(20,454)	(6,636)	1,589	40,745	8,337	2,746	**207,301**
Net nonoil commod imports H1 2015	118,954	23,734	(15,941)	(4,106)	708	28,864	6,137	3,196	**161,545**
Reduction in commod. Imports	97,252	12,764	1,566	(1,004)	1,964	30,190	9,449	6,140	**158,321**
Trade bal H1 2014	102,523	(61,702)	(1,129)	13,672	(1,378)	19,885	16,212	33	**88,116**
Trade bal H1 2015	263,273	(58,162)	4,403	11,448	(1,837)	46,118	25,807	3,473	**294,522**
Change in trade balance	160,750	3,539	5,532	(2,224)	(460)	26,233	9,595	3,440	**206,406**

Source: Nomura, CEIC, Bloomberg. Note: excludes Singapore and Hong Kong. Non-oil commodities refers to our estimate of non-oil hard commodities trade as classified by official sources.

Local factors

Korea

We expect KRW to be one of the main underperformers in the region and reach 1,250 (against USD) by end-2016. Globally, monetary policy divergence should pressure KRW given the stronger transmission of rate policy differentials to KRW since 2010 (see *Asia Special Report - The Bank of Korea is approaching uncharted territory*, 9 September 2015) and the high sensitivity of KRW to broad USD strength, as well as EUR and JPY depreciation. The Fed is expected to hike its policy rate a total of three times before the end of 2016, compared with our forecast two 25bp BOK rates cuts (starting February). China downside growth risks and depreciation of RMB and JPY will also add to KRW depreciation pressure given strong China economic and financial channel linkages (see *First Insights - Asia linkages to China*, 24 July 2015).

Locally, we believe the Korean authorities will tolerate KRW weakness within their pro-growth stance ahead of the April legislative election. Indeed, adjusted FX reserves show that the BOK accumulated USD in October to lean against KRW appreciation; it accumulated USD17.5bn in January-to-November 2015. Capital outflow measures announced in June 2015 to be passed in parliament at the start of 2016 will also hurt KRW sentiment (see *Limited FX/rates impact from Korea capital outflow measures*, 29 June 2015). Further, we also see a risk of ship order cancellations, which could result in the unwinding of short USD/KRW hedges (Figure 67).

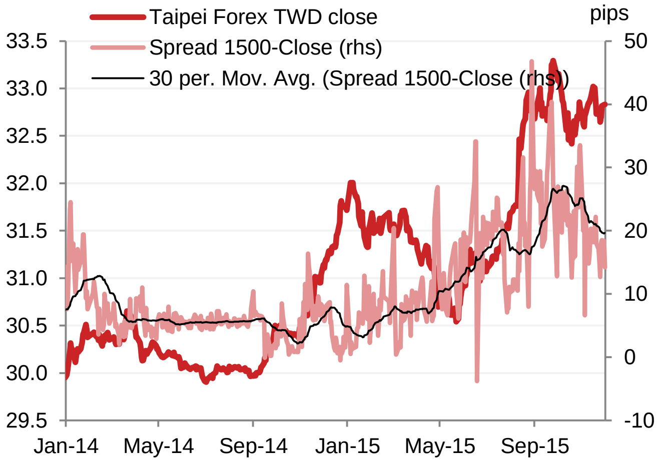
The main risks to our view of KRW depreciation include Korea's strong current account surplus, forecast at 8.4% of GDP (USD120bn) in 2016, KRW's slight undervaluation at 2.2% and better global growth given KRW sensitivity to foreign equity inflows.

Fig. 67: Estimated unwind requirement in USDbn

Company	Value of deliveries	Estimated outstanding hedges	50% of cancelled/ delayed
USD bn			
Hyundai Heavy	13.2	7.6	3.8
Samsung Heavy	10.9	7.7	3.8
Daewoo Shipbuilding	18.1	7.0	3.5
Total	42.2	22.2	11.1

Source: Nomura Equity. Note: Hyundai Heavy hedge ratio assumed at 82.5%, Samsung Heavy hedge ratio at 100%, Daewoo Shipbuilding hedge ratio at 55%.

Fig. 68: Spot USD/TWD closing notably higher at the end of each trading session



Source: CEIC, Bloomberg, Nomura

Taiwan

We forecast TWD to weaken to 34.2 against USD by end-2016 given the negative impact of China developments and Fed hikes in 2016. Locally, negative TWD factors include the weak macro backdrop, our out-of-consensus call for a December CBC rate cut, authorities' preference for a weaker TWD and political concerns related to the presidential and legislative elections.

Given already low interest rates, there is also the perception that TWD weakness may be an important policy tool to provide more support to growth, especially since the weakest link in GDP is exports. Taiwan authorities' preference for a weaker TWD is seen from its almost consistent gains in monthly adjusted FX reserves (totalling USD17.1bn in January-to-October 2015). This is also in line with our observation of spot USD/TWD closing notably higher at the end of each trading session since the middle of 2015 (Figure 68; see *Asia Insights - US Treasury tones down its criticism of China and Korea*, 20 October 2015).

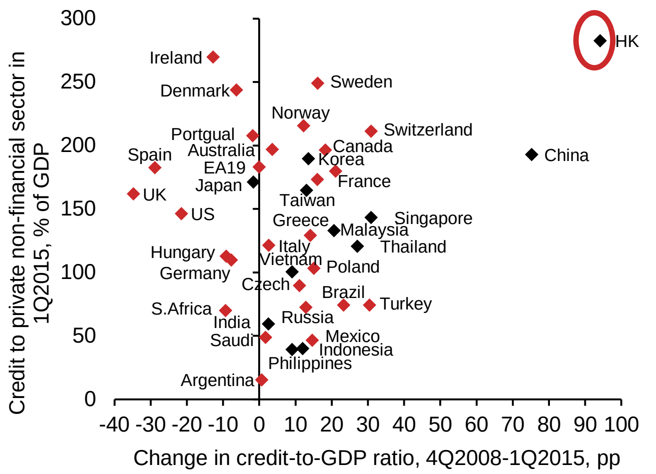
Risks to our view of TWD depreciation include the current account surplus, which is forecast at 10.4% of GDP (USD53bn) in 2016, TWD's large undervaluation at 20.1% and if global growth surprises given TWD's sensitivity to foreign equity inflows.

Hong Kong

Focus on HKD has risen because of the RMB depreciation and USD/CNY fixing regime change on 11 August 2015. The associated RMB depreciation sparked large capital outflows from China as investors became concerned with the potential for further depreciation. At the same time, RMB deposits in Hong Kong also experienced the largest drawdown in the month of September at RMB84bn (USD13bn), followed by another RMB41bn (USD6.5bn) in October as investors likely switched over to HKD given the USD peg. This resulted in the HKD7.75 strong-side convertibility undertaking rate being touched, triggering the injection of HKD liquidity, which placed downside pressure on local rates and led the 12m forward points to trade down -85 pips. We believe this capital inflow will be temporary and not sustained over the medium term.

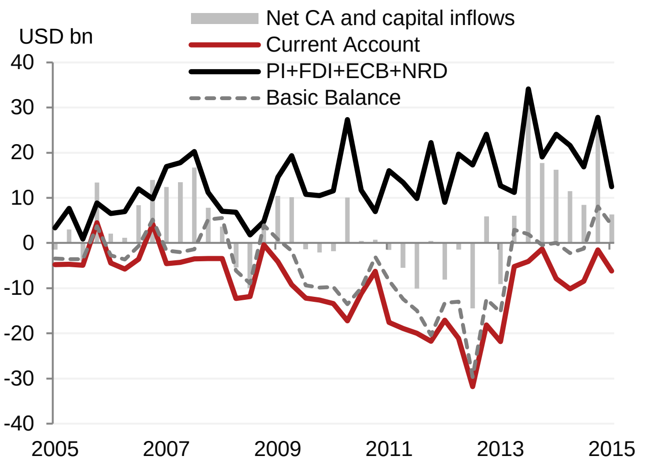
Overall, our baseline is no change in the USD/HKD peg regime in 2016, but we do see risks of spot trading higher to 7.82 by end-2016 (around a 1.0% total return from being long 12m USD/HKD), while forward points are likely to be in premium and volatility is likely to remain relatively low. The rationale for this includes the China slowdown and Hong Kong's economic dependence on the mainland from trade, financial channels and tourism. RMB depreciation could also add to concerns over the USD/HKD peg, given the rising HKD overvaluation (currently around 9.5% on a trade-weighted basis). There are also risks from the property market, with high private sector credit at 292% of GDP (as of Q1 2015) and the impending start of the Fed tightening cycle (Figure 69).

Fig. 69: Hong Kong: Private sector credit stands out



Note: *Private credit refers to loans and debt securities provided domestically and by non-residents to private non-financial corporations and households. Source: CEIC, Nomura.

Fig. 70: India: Capital flows



Note: PI = Portfolio investment; FDI = Foreign Direct Investment; ECB = External Commercial Borrowing; NRD = Non-resident Deposits. Source: CEIC, Nomura.

India

In 2016, we expect INR to outperform the region with prospects boosted by India's continued cyclical recovery – it is set to have the highest growth in Asia, with controlled inflation – continued positive sentiment towards the Modi/Rajan administration and diminished external vulnerability. In the context of our main themes for the year, the dynamics of INR offer offsets to most of our major concerns. As a domestically oriented economy with its largest share of exports destined for the US, India is less exposed to the slowdown in China than the rest of Asia. In addition, domestic conditions are set to improve: our economists continue to expect an acceleration in private and government consumption, boosted by the cumulative impact of the RBI's rate cuts, de-bottlenecking of projects and progress with infrastructure investments.

Beyond this, our outlook for INR is enhanced by our expectation of continued economic reforms and their impact on broader inflows. In addition to the favourable macro-economic backdrop; the government's FDI reforms (see *Asia Insights - INR: FDI reforms announced*, 11 November 2015); the stabilisation of rural wages; the push for international trade and investment (contributing to openness); and a favourable policy backdrop (demonstrated by India's rising "ease of doing business" ranking) should foment further capital inflows, contributing to India's growing balance-of-payment strength (Figure 70). In the medium term, we believe further REER appreciation is justified based on still-favourable INR FX valuations (acknowledged by the RBI[10], Figure 57) as well as continued strong productivity growth (see *Asia Special Report - INR: Sustained strength lies ahead*, 24 July 2015).

Risks to our positive INR view stem primarily from concerns over policy paralysis, particularly in light of the recent Bihar election result (see *Asia Chart Alert - India: The Upper House arithmetic*, 10 November 2015). In 2016, investor attention is likely to be keenly focussed on landmark reforms including the GST Constitutional Amendment, Bankruptcy Bill and Land Acquisition Bill (see Box 8: Reforms in India to watch out for in 2016). Besides these, the government could continue to push through executive reforms (as it did after the Bihar election), which would demonstrate to investors its conviction on its reform agenda. Aside from this, there could be concerns over policy continuity following the end of RBI Governor Rajan's term in September (although we note that his term could be extended by another two years).

Philippines

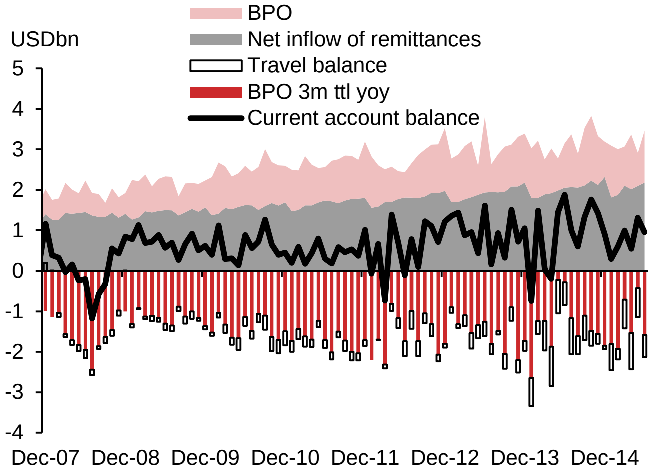
For 2016, our economists expect GDP growth to accelerate to 6.5% (second only to India) from 5.8% in 2015, led by domestic demand. The favourable growth backdrop is positive for PHP flow dynamics, with strengthening FDI inflows adding to FX earnings from remittances and BPO services (Figure 71). In 2015, remittance growth (adjusted for FX) has averaged 8.5% y-o-y, with limited signs of impact from the drop in oil prices. On BPO, we note that sentiment in the sector has remained strong, with the Information

[10] "Rajan Says No Target on Rupee; One of Strongest Currencies", *Bloomberg*, 20 November 2015.

Technology and Business Process Association of the Philippines expecting 2016 BPO revenues to hit USD25bn (+18% y-o-y). Simultaneously, portfolio flows appear to have stabilised with October registering net inflows after seven months of outflows.

The May presidential election will be of focus, with Senator Poe the current front-runner (based on recent polls; see above). However, it is expected to be a close contest, with added impetus for President Aquino to provide fiscal support to growth to boost the chances of his candidate, Mar Roxas. Additionally, the market's focus on the fundamental strength in the Philippine economy should engender PHP outperformance: our economists expect 50bp of rates hikes from next year, the only central bank in the region following the Fed in tightening monetary policy.

Fig. 71: Philippines: External position supported by BPO and remittances



Source: CEIC, Nomura Note: BPO is estimated from Telecom, computer and Info. Services, and other business services

Fig. 72: SGD has the highest sensitivity to DXY, EUR, JPY

Beta (weekly return over 3Y)	DXY	EUR	JPY
SGD	44.4%	29.1%	25.7%
KRW	26.8%	12.8%	16.9%
MYR	23.3%	12.3%	6.9%
THB	17.9%	9.6%	9.0%
INR	15.1%	8.6%	2.8%
IDR	14.9%	7.5%	6.7%
TWD	12.2%	4.7%	7.7%
PHP	5.3%	0.9%	1.7%
CNY	1.0%	0.2%	1.5%

Source: Bloomberg, Nomura.

Singapore

We forecast USD/SGD to trade higher through 2016, to end the year at 1.50, providing a total return of 5.9%. Globally, SGD should come under more pressure from broad USD strength, our view of China growth slowing and associated RMB depreciation. Singapore's open economy and the MAS FX basket monetary policy regime means that SGD has a high sensitivity to global economic developments, as well as moves in DXY, EUR and JPY (Figure 72).

Domestically, we believe the MAS' October 2015 outlook for higher inflation and modest growth in 2016 implies that a further easing in FX policy is unlikely over the next 12 months. The MAS official core inflation forecast is 0.5-1.5%, while MTI forecasts growth in the range of 1-3%. However, given the risks to China and global growth, the risks of further policy easing by the MAS are non-negligible. A further easing in FX policy (if it emerges in 2016) would likely be a short-term response to a weak macroeconomic backdrop and not represent a change in the medium- to long-term S$NEER appreciation bias to help raise productivity growth (see *Asia Special Report - Singapore's productivity conundrum*, 23 October 2015). In addition, rising short-term rates as a direct consequence of higher US rates could also increase concerns over Singapore's high domestic debt. Overall, we expect the S$NEER to trade from the midpoint to the extreme weak side of the policy band over coming quarters and currently hold a greater bias towards being short (rather than long) S$NEER.

Malaysia

MYR was beset by a number of concerns in 2015 including worries over a Fed lift-off, low commodity prices and local politics. A Fed lift-off was considered a significant risk for MYR due to the high level of foreign ownership of local-currency debt[11] (peaking at 46.5% of outstanding, or USD65bn equivalent in July 2014). However, with USD8.5bn of net foreign bond outflows (primarily in BNM bills of USD10bn) since the peak to August 2015, foreign positioning has lightened significantly. Indeed, confidence appears to be stabilising with September and October registering bond inflows of MYR9.2bn, after a resumption of BNM bill issuance in August and with a December lift-off now fully priced-in (Figure 73).

[11] Includes conventional government securities and BNM bills only.

Commodity prices remain low, and with our view that there is unlikely to be any significant price gains in 2016, support for Malaysia's exports are likely to be limited. However, even with a stable commodity price backdrop, this should alleviate further negative impacts and concerns on local markets, especially given that Malaysia's growth, current account and fiscal positions have proved quite resilient to the negative terms of trade shock.

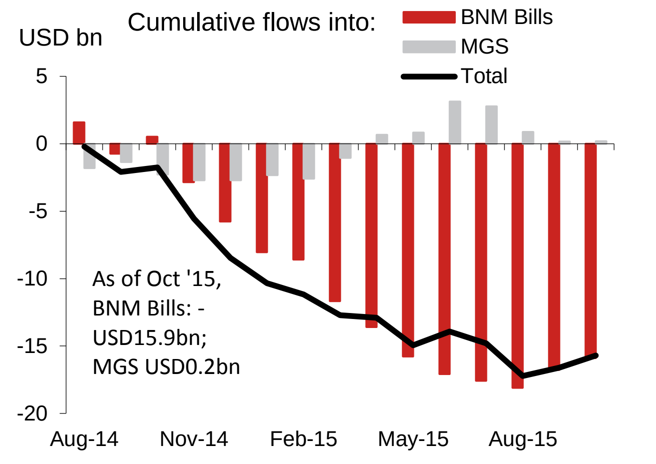
On politics, we see issues surrounding the beleaguered state-owned company, 1MDB, and Prime Minister Najib moving to the sidelines. It is clear that broad UMNO support for Najib continues, while in the absence of new evidence, we believe it remains unlikely that the Attorney General will initiate criminal proceedings against him.

Overall, a lot of negative MYR factors are now broadly priced in, in our view. Unless there is substantial weakness in China, commodity prices fall substantially further and/or an unforeseen external shock emerges, we believe MYR – the Asian currency that depreciated the most in 2015 – could experience periods of outperformance in 2016 and remain relatively stable.

Aside from the Fed, commodities and local politics, further weakness in MYR could also be limited by: 1) relatively strong macroeconomic fundamentals, with GDP growth forecast at 4% in 2016 despite the weak external environment; 2) MYR's significant undervaluation of around 9.6%; 3) announced policy measures such as delaying capital goods imports and foreign-currency repatriation by government-linked corporations; and 4) the capacity of authorities to announce policies that include external financing channels, using local currency in bilateral trade settlement, and others (see *Asia Insights - MYR: Possible policy steps ahead*, 11 September 2015).

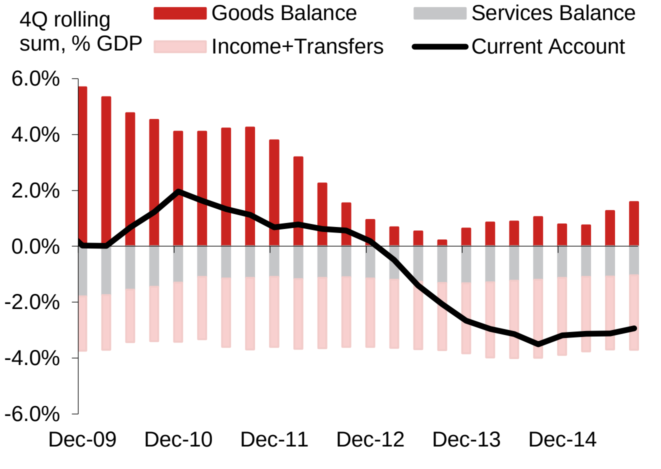
However, there are some risks in 2016, such as the succession of BNM Governor Zeti, who is retiring in April (announcement likely in January) and concerns over Malaysia's external debt burden (at 71.2% of GDP, the highest in the region bar Singapore and Hong Kong; Figure 5: Vulnerability scorecard). Additionally, there are some risks of LNG exports disappointing due to the lagged effect of crude oil on LNG prices and additional LNG supply for Asia from new US and Australian exports.

Fig. 73: Malaysia: Foreign holdings of bonds and bills



Source: CEIC, Nomura.

Fig. 74: Indonesia BOP – selected components



Source: CEIC, Nomura.

Indonesia

In our view, the structural concerns that brought about IDR depreciation and under-performance in 2015 could ease at the margin in 2016. IDR is likely to benefit from incrementally positive domestic developments, including an improvement in domestic demand, an acceleration in public capex and improving political dynamics (see *Asia Special Report - Indonesia: Silver linings*, 25 November 2015). Furthermore, our rates strategy team has turned neutral on Indonesian bonds (from underweight) with the more constructive economic outlook, attractive real yields and manageable bond supply (see Asia rates: Be selective; stay local). Bond inflows will remain an important source of financing the current account deficit in 2016.

The main global risks are Fed hikes and slowing China growth, while local concerns are Indonesia's dual-deficit and high foreign investor ownership of local-currency bonds. Our concerns over Indonesia's current account stem from the persistent nature of the services deficit and outward repatriation. Consequently, the narrowing of the goods surplus from a post-crisis peak of 5.7% of GDP in Q4 2009 to 1.6% in Q3 2015 (Figure 74) has kept the current account in deficit. That said, if our assumption of stable commodity prices emerges in 2016, concerns over the external position should fall as Indonesia is a net exporter of commodities.

We believe BI is likely to cut rates soon after the Fed (Nomura sees -50bp before end-Q1 2016). For FX, rate cuts can be considered positive for IDR only in a very benign risk environment where global demand (particularly for commodities) is stable and the perceived benefits of monetary accommodation outweigh concerns over monetary policy divergence.

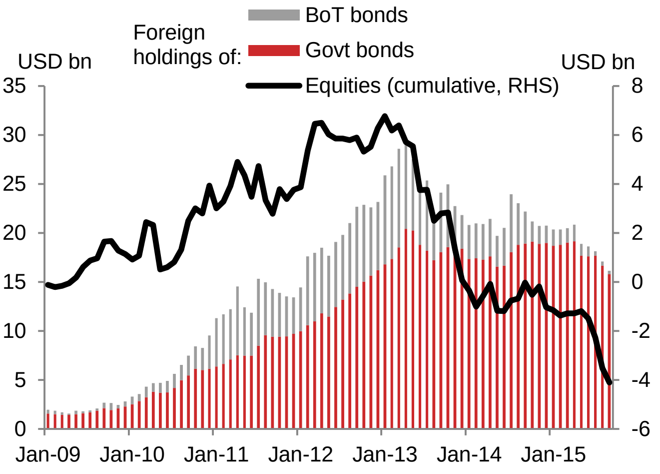
Thailand

Our economists have maintained their bearish outlook on Thailand due to weak external demand and ongoing domestic concerns. Political uncertainty is expected to drag on public and private sector spending, which, in our view, will continue to weigh on THB. We expect GDP growth of 2.5%, which is below official forecasts from the National Economic and Social Development Board (3-4%), the Fiscal Policy Office (3.3-4.3%) and BOT (3.7%). While the government has announced fiscal packages of as much as 2.6% of GDP, the impact is likely to be limited given the significant implementation risks. Consequently, our economists expect further easing in the form of 50bp of rate cuts in H1.

Against this backdrop, we see few catalysts that could turn foreign investor sentiment positive towards Thailand and THB. Foreign portfolio investment has been declining since 2013, possibly due to the taper tantrum followed by the riots in late 2013 (Figure 75); since January 2013, investors have pulled USD9.7bn from BOT and government bonds, and USD11.2bn from equities (latest available data). Indeed, subdued foreign interest is part of the reason why our Rates strategy team is bearish on the yield curve (see Asia Rates Outlook – Be selective, stay local). Additionally, while tourist arrivals – a key source of FX income – recovered following the riots, the August bombing in Bangkok could have contributed to the recent decline in visitors (Figure 76).

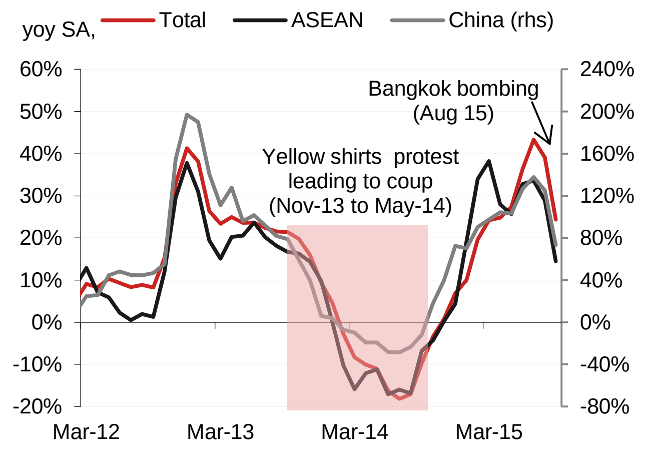
With a weak external sector that is susceptible to the China slowdown and concerns over financial stability risks, we believe the BOT is likely to maintain its policy preference for a weaker THB. A constraint to this preference, however, is Thailand's sizeable current-account surplus, which is expected to reach 6.6% of GDP this year. Nonetheless, with persistent disinflation, weak domestic dynamics, a reliance on the external sector for growth and more accommodative monetary policy, we expect THB to underperform in 2016, depreciating against USD by 5.3%.

Fig. 75: Thailand: Portfolio flows



Source: CEIC, Bloomberg, Nomura

Fig. 76: Thailand visitor arrivals



Source: CEIC, Nomura

Appendix A

Fig. 77: Asian FX forecasts

Asia FX Forecast			% q-o-q	% q-o-q	% q-o-q	% q-o-q	% y-o-y
	04-Dec-15	End-2015	1Q16	2Q16	3Q16	End-2016	End-2017
Chinese Renminbi Onshore	6.3917	6.45 ↓	6.54 ↓	6.64 ↓	6.72 ↓	6.80 ↑	6.79 ↑
Change (%)		*0.9*	*1.4*	*1.5*	*1.2*	*1.2*	*-0.1*
Forward		*6.42*	*6.50*	*6.56*	*6.60*	*6.64*	*6.80*
Actual total return (%)		*-0.5*	*-0.6*	*-1.3*	*-1.8*	*-2.4*	*0.2*
Chinese Renminbi Offshore	6.4312	6.48 ↓	6.56 ↓	6.65 -	6.73 ↓	6.80 ↑	6.79 ↑
Change (%)		*0.8*	*1.2*	*1.4*	*1.2*	*1.0*	*-0.1*
Forward		*6.45*	*6.51*	*6.56*	*6.60*	*6.64*	*6.78*
Actual total return (%)		*-0.5*	*-0.8*	*-1.4*	*-2.0*	*-2.4*	*-0.2*
Hong Kong Dollar	7.7503	7.75 ↓	7.77 ↓	7.80 -	7.81 ↓	7.82 -	7.81 ↑
Change (%)		*0.0*	*0.2*	*0.4*	*0.1*	*0.1*	*-0.1*
Forward		*7.75*	*7.75*	*7.74*	*7.74*	*7.74*	*7.74*
Actual total return (%)		*-0.1*	*-0.3*	*-0.7*	*-0.9*	*-1.0*	*-0.9*
India Rupee	66.88	66.7 ↑	66.9 ↑	67.2 ↑	67.3 ↑	67.4 ↑	65.0 ↑
Change (%)		*-0.3*	*0.3*	*0.4*	*0.1*	*0.1*	*-3.6*
Forward		*67.1*	*68.1*	*69.1*	*70.2*	*71.2*	*75.1*
Actual total return (%)		*0.7*	*1.8*	*2.9*	*4.2*	*5.6*	*15.5*
Indonesia Rupiah	13838	14000 ↓	14200 ↓	14450 ↓	14650 ↓	14850 ↓	14600 ↓
Change (%)		*1.2*	*1.4*	*1.8*	*1.4*	*1.4*	*-1.7*
Forward		*13908*	*14205*	*14525*	*14829*	*15171*	*16536*
Actual total return (%)		*-0.7*	*0.0*	*0.5*	*1.2*	*2.2*	*13.3*
Malaysian Ringgit	4.2265	4.20 ↓	4.23 ↓	4.31 ↓	4.36 ↓	4.40 ↓	4.28 ↓
Change (%)		*-0.6*	*0.7*	*1.9*	*1.2*	*0.9*	*-2.7*
Forward		*4.22*	*4.24*	*4.25*	*4.27*	*4.29*	*4.35*
Actual total return (%)		*0.6*	*0.1*	*-1.3*	*-2.0*	*-2.5*	*1.6*
Philippines Peso	47.09	47.1 ↑	47.3 ↑	47.6 ↑	47.9 ↑	48.1 ↑	46.8 ↑
Change (%)		*0.0*	*0.4*	*0.6*	*0.6*	*0.4*	*-2.7*
Forward		*47.2*	*47.5*	*47.8*	*48.0*	*48.2*	*49.1*
Actual total return (%)		*0.3*	*0.5*	*0.4*	*0.2*	*0.2*	*4.8*
Singapore Dollar	1.3979	1.42 ↓	1.45 ↓	1.47 ↓	1.49 -	1.50 ↑	1.46 ↓
Change (%)		*1.6*	*2.1*	*1.4*	*1.4*	*0.7*	*-2.7*
Forward		*1.40*	*1.40*	*1.41*	*1.41*	*1.41*	*1.42*
Actual total return (%)		*-1.5*	*-3.3*	*-4.4*	*-5.5*	*-5.9*	*-2.6*
Korean Won	1157.3	1170 ↓	1200 ↓	1230 ↑	1245 ↑	1250 ↑	1210 -
Change (%)		*1.1*	*2.6*	*2.5*	*1.2*	*0.4*	*-3.2*
Forward		*1158*	*1160*	*1162*	*1162*	*1163*	*1168*
Actual total return (%)		*-1.0*	*-3.3*	*-5.6*	*-6.6*	*-7.0*	*-3.5*
New Taiwan Dollar	32.72	32.9 ↓	33.6 ↓	33.9 ↑	34.1 ↑	34.2 ↑	33.3 -
Change (%)		*0.6*	*2.1*	*0.9*	*0.6*	*0.3*	*-2.6*
Forward		*32.7*	*32.7*	*32.7*	*32.7*	*32.7*	*32.8*
Actual total return (%)		*-0.5*	*-2.6*	*-3.5*	*-4.1*	*-4.4*	*-1.6*
Thai Baht	35.78	36.1 ↓	36.6 ↓	37.1 ↓	37.6 ↓	38.0 ↓	38.0 ↓
Change (%)		*0.9*	*1.4*	*1.4*	*1.3*	*1.1*	*0.0*
Forward		*35.8*	*35.9*	*36.1*	*36.2*	*36.4*	*37.1*
Actual total return (%)		*-0.8*	*-1.8*	*-2.8*	*-3.7*	*-4.3*	*-2.4*

Asia FX Forecast (Previous)							
	06-Oct-15	End-2015	1Q16	2Q16	3Q16	End-2016	End-2017
Chinese Renminbi Onshore	6.3561	6.50	6.60	6.65	6.75	6.75	6.75
Chinese Renminbi Offshore	6.3565	6.50	6.60	6.65	6.75	6.75	6.75
Hong Kong Dollar	7.7501	7.77	7.80	7.80	7.82	7.82	7.79
India Rupee	65.36	65.9	66.5	65.8	66.0	65.6	63.6
Indonesia Rupiah	14272	14800	15100	14800	15100	15200	15700
Malaysian Ringgit	4.3830	4.55	4.65	4.55	4.60	4.60	4.40
Philippines Peso	46.44	46.7	47.2	47.0	47.1	46.8	45.5
Singapore Dollar	1.4268	1.47	1.49	1.48	1.49	1.49	1.49
Korean Won	1166.2	1210	1240	1220	1240	1240	1210
New Taiwan Dollar	32.84	33.5	34.0	33.5	33.8	33.8	33.3
Thai Baht	36.37	37.5	38.3	37.8	38.0	38.2	39.0

Source: Nomura.

Asia rates: Be selective; stay local

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Summary of trade recommendations

We recommend the following trades into 2016 (see country pages for more detail):

- **China**: Long 5yr CNH CGBs; look for opportunities to receive front-end of swap curve
- **India:** 1s5s, 2s5s NDOIS flatteners and long 9yr IGBs into Q1 2016; look to enter long 5yr IGBs and long 5yr bond vs 5yr swap spread.
- **Korea**: 3s10s and 2s5s IRS steepeners; look to enter 1yr outright receive.
- **Thailand**: 3yr NDIRS receivers and 2s5s steepeners.
- **Malaysia**: Receive 1s3s10s and 1s2s5s as proxy steepeners; look to initiate outright receivers in 2yr and 3yr part of the curve.
- **Singapore**: 2s5s flatteners and receiving the belly of the SGD swap curve through 2s5s10s/3s5s10s flies
- **Hong Kong**: Pay 10y IRS and 2s5s IRS steepeners.
- **Australia**: 3m fwd1s3s swap flatteners.

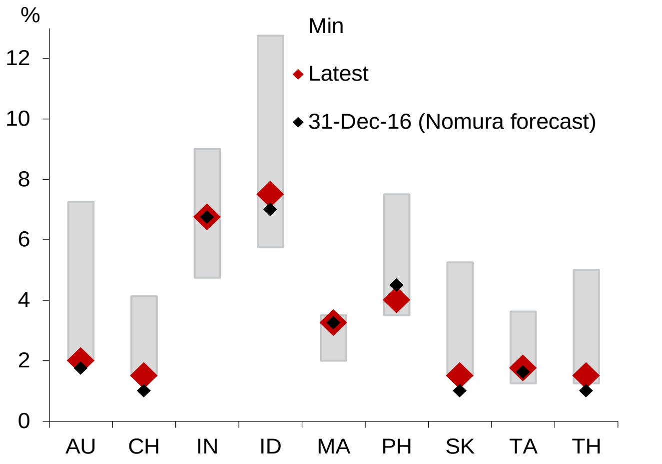
Key factors that affect our Asian rates outlook for 2016

For 2016, we suggest investors focus on local dynamics and take a selective and differentiating approach to Asia rates markets. 2016 will be a year where the Fed is expected to hike rates; however, despite the expected Fed tightening, we believe local factors will end up being a prominent driver of rates markets. From a top-down perspective, we believe the following key factors are most important in shaping our Asia rates market outlook for 2016:

Monetary policy divergence from the US
We are constructive on the front-end rates of various countries despite the Fed tightening. A key focus of our 2016 rates outlook is monetary policy divergence from the US. This theme is also evident in the developed world, where we expect Fed to hike rates by three times by end-2016 while we expect Europe and Japan to continue QE. For Asia rates, we also expect Asia central banks to decouple from the US, either by staying on hold or cutting further in 2016 (Figure 78). This should provide opportunities in the front-end rates of many Asia markets, such as Thailand, Korea and Malaysia. In Thailand and Korea, our economics team expects central banks to ease further. Similarly, we also look to receive in countries where we believe the monetary tightening premium currently priced into the curve will not be realised, such as Malaysia. On Indonesia bonds, we have turned more neutral after being underweight, given attractive real yields (see Box 11: Bond valuations) and expected monetary easing.

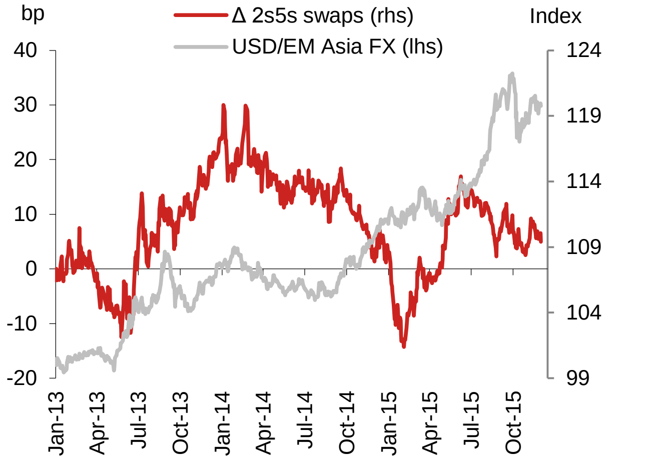
Higher term premium for select countries during Fed hiking cycle
While we expect most front-end Asia rates to be capped, we do see term premiums rising in some countries as the Fed enters a rate hike cycle. The catalysts for higher back-end rates could be the fiscal situation (bond-supply driven), capital flows or simply valuations. Higher bond supply is expected in 2016 in countries like Thailand and Malaysia. The other potential driver for a steeper curve is higher back-end US rates. While our US rates strategists only expect a modest increase in 10y UST yield to 2.5% in H2 2016, this could still exert some steepening pressure on low yielding countries like Korea, Thailand and Malaysia. The yield curve could also steepen to reflect risk premiums related to capital outflow concerns in countries such as Malaysia and Thailand.

Fig. 78: Monetary policy range, latest and forecast



Source: Nomura, Bloomberg

Fig. 79: Yield curve dynamics



Note: USD/EM Asia FX indexed to 100 on 1-Jan-13 and average % change in Asia EM FX (includes USD/CNY, USD/INR, USD/IDR, USD/MYR, USD/KRW, USD/PHP, USD/SGD, USD/THB and USD/TWD) since then is used to generate the USD/EM Asia FX series. Similarly, 2s5s swaps are tracked as the average change in bp across the swap curves since 1-Jan-13. Source: Nomura, Bloomberg

A gradual Fed hiking cycle amid slower global growth

We note that our US economics team expects a very gradual Fed hiking cycle – our base case is that Fed lift-off will occur this month and be followed by two 25bp rate hikes in June and Q4 2016. Rates in Singapore, Hong Kong and Australia are highly correlated with US rates, and are therefore most susceptible to how the dynamics around the Fed hiking cycle evolve. A shallow US hiking cycle makes us believe that, despite the high historical correlation with US rates, rates markets in Singapore, HK and Australia will be able to respond to local factors more than in past US rates cycles. In Singapore, higher term-funding rates should keep the front end elevated, while term structure should fall, aided by the gradual Fed hiking cycle. In Australia, we like front-end flatteners, as these should capture our low-for-long theme and also offers attractive roll. In HK, we expect flush interbank liquidity to keep HIBOR fixings stable so the curve can steepen.

Local and liquidity dynamics in China and India

In the two biggest economies, China and India, we expect local and liquidity dynamics to be the primary drivers of rates markets. In China, our economists' forecast of two policy rate and four RRR cuts in 2016 (see China – where the rubber hits the road) bodes well for fixed income, in addition to further capital account liberalisation and opening of local bond markets. High grade bonds, like CGBs should outperform, as spreads widen on credit concerns. However, liquidity dynamics are also important, as we expect the interbank rate to decline only modestly given FX outflow risks. Thus, we expect CGBs to outperform swaps.

In India, we believe markets will move away from monetary policy as the primary driver of rates markets, which was an important feature in 2015. We believe liquidity, supply and demand of bonds, and fiscal and inflation dynamics will become important drivers in 2016. Given stable monetary policy and the RBI's focus shifting to transmission of rate cuts, we expect front-end rates and the belly to remain stable. Local bond markets should also benefit from foreign investors participation. We maintain an overweight stance on India bonds, although we expect the belly of the curve (5yr) to outperform the back end. Underperformance in the longer end may become prominent towards the second half of the fiscal year, when we expect the market to gradually build in inflation risk premiums.

Box 11: Bond valuations

We look at various metrics for bond valuations, including expected real 10yr bond yields (based on current 10yr yields and Nomura's 2016 inflation forecasts), 10yr bond yields adjusted for FX hedging costs, expected real yields adjusted for sovereign risk, spread (as a range) and correlation with UST 10yr yields and foreign positioning (wherever available).

We note that Indonesia bonds have the most attractive expected real yield (based on our 2016 inflation forecast) and they remains attractive (compared with most other countries) even after adjusting for sovereign risk. Singapore has the most attractive sovereign risk adjusted real yield, while Malaysia bonds are most attractive on an FX hedged basis. India is worth highlighting, as it appears attractive on most of our metrics and also has very low correlation with US Treasuries.

Fig. 80: Bond valuation metrics

	10yr yield - CPI 2016f	10yr yield - 12m FX implied yield	10yr yield - CPI 2016f - 5yr CDS	Real yield* (% of range**)	Spread with 10yr UST (as % of range**)	Correl with UST 10yr***	Foreign positioning in govt. bonds
	(%)	(%)	(%)	(%)	(%)		
Indonesia	3.91	-1.22	1.70	48%	72%	64%	37.9% (Oct)
Singapore	2.61	0.91	2.43	99%	80%	74%	
India	1.99	0.94	1.39	94%	56%	25%	3.8% (IGB, Nov)
Thailand	1.53	0.37	0.26	92%	33%	48%	15.9% (Oct)
Philippines	1.37	1.30	0.37	92%	33%	35%	
China	1.28	-1.11	0.29	85%	51%	64%	2.40% (Sep)
Australia	0.76	0.54	0.37	32%	13%	79%	65.2% (Jun)
Korea	0.75	1.30	0.22	62%	7%	59%	12.8% (KTB, Oct)
Taiwan	0.49	0.59	0.31	66%	64%	54%	
Malaysia	0.20	2.29	-1.51	43%	82%	63%	46.3% (MGS, Oct)
Hong Kong	-0.94	0.98	-1.34	55%	51%	95%	

Note: * Real yield calculated as 10yr govt bond yield less 3m average headline inflation; ** Range since Jan 2010; *** Correlation between levels over the past five years on a daily basis; Note: Levels and data as available on 30 November 2015. Source: Nomura, Bloomberg, BNM, NSDL, BOT, AOFM, BOK, BI

China: Trading macro versus micro (long 5yr CNH CGB)

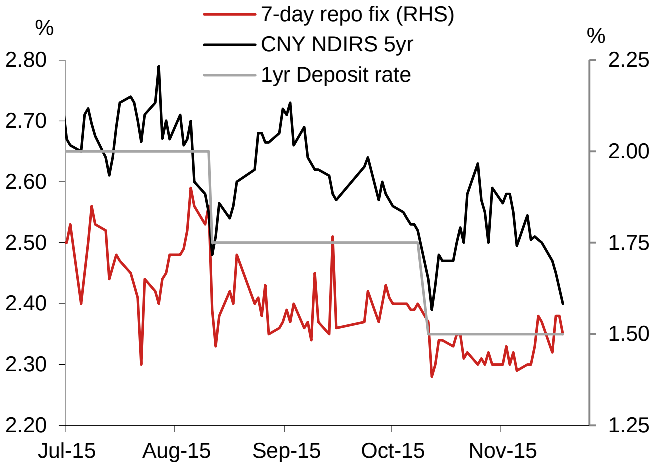
Throughout 2015, the market viewed a China growth slowdown as one of the biggest global risks. Indeed, the PBOC cut the RRR (and or) policy rate seven times so far in 2015. Our China economic growth outlook is clear, with our economist, Yang Zhao, forecasting well-below-consensus GDP growth of 5.8% in 2016.

However, from a rates strategy perspective receiving China rates has been less straightforward than the macro trend. While China IRS declined substantially in H1 2015, they largely traded in a 30-40bp range in 2H15, even though substantial monetary easing continued. This is primarily because the more recent policy rate/RRR cuts have not translated into a much lower 7d repo fixing (Figure 81), as excess interbank liquidity has decreased – from 2.5% of deposits in Q2 to 1.9% in Q3 before likely stabilising in Q4. Also, we believe the PBOC was trying to prevent interbank rates moving too low over concerns of exacerbating FX outflows after the August RMB devaluation. That said, the pattern may change in 2016. Our FX strategist Craig Chan expects FX intervention to moderate in 2016 as China moves towards a more market-driven exchange rate regime. This should allow better transmission of policy rate cuts to the interbank rate.

Meanwhile, CGBs outperformed IRS in H2 2015, and we believe this trend will continue in 2016. CGBs have much better valuations than IRS, with 5yr CGBs at more than 100bp above overnight funding cost. In contrast, 5yr NDIRS are only 10-15bp above the 7d repo fixing. In addition, CGBs can benefit from safe-haven flows if corporate default rates increase or bank loan growth slows as the economy moderates. We forecast 10yr CGB yields reaching 2.60% by end-2016 with risk of a larger decline. However, since most investors cannot access onshore bonds, the second best option would be to buy CNH CGBs. These currently trade 30-50bp above onshore CGBs. However, as offshore funding costs are much higher than onshore with 1y CCS currently above 3.5%, this would mainly be a long duration trade rather than a carry trade. We believe the new 5yr CNH CGB benchmark, currently trading at 3.41%, has the best risk/reward along the curve (Figure 82). We suggest positioning long this bond (CGB 3.4% 11/30/20) with a target of 3.00% and reassess at 3.60% for 3K DV01. We hedge 80% of the FX exposure via a 1y CNH CCS, currently at 3.65% with USDCNH reference at 6.446.

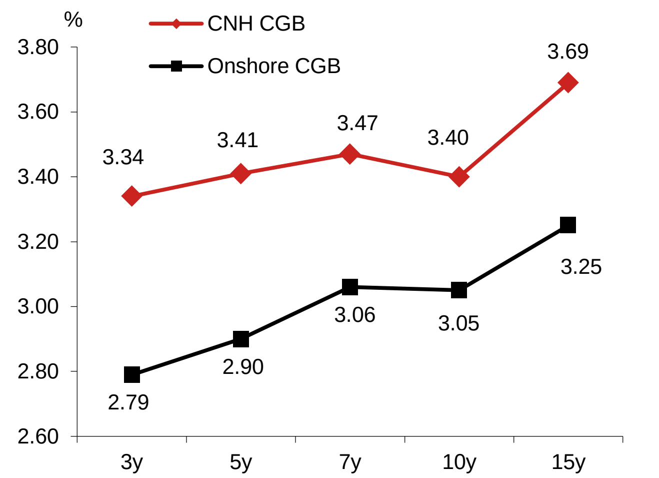
Turning back to IRS, we believe both the 7d repo fixing and IRS have limited downside until Chinese New Year (early February) as liquidity tends to tighten seasonally. However, with our house view of two policy rate cuts starting in Q2 2016, we think the 7d repo could eventually fall to 2.0%, or even lower, in H2 2016. An opportunity to receive front-end NDIRS could present itself sometime in late Q1 2016, but timing is critical. We remain open to receiving front-end IRS as and when the opportunity arises. Finally, on CNH CCS, we expect CCS to continue to trade above IRS due to expectations of RMB depreciation. However, the current spread of over 150bp (for 1y) is too high, in our view. It should gradually narrow in 2016 as China further liberalises its capital account and promotes closer integration between the onshore and offshore markets after IMF SDR basket inclusion.

Fig. 81: 1yr target deposit rate, 7d repo and 5yr NDIRS (%)



Source: Nomura, Bloomberg

Fig. 82: Onshore and CNH CGB yield curve (%)



Source: Nomura, Bloomberg

India: Long 5yr bond; 5yr bond swap spread

In India, we expect monetary policy to become less of a driver of rates markets. Our economics team, Sonal Varma and Neha Saraf, sees the RBI staying on hold for all of 2016 (see India: Both growth and macro risks to rise). We remain constructive on bond markets, and expect 10yr bond yields to trade 40bp over the 1yr T-Bill rate, on an average. While we forecast no changes in the policy rate, we expect the RBI to increase its focus on rate cut transmission. In this process, we expect the RBI to keep ample liquidity in the banking system. This should put downward pressure on 1yr T-Bill rates which we expect to move towards 7% over the course of year. Assuming 1yr T-Bill rates reach 7% by mid-year, we would expect 10yr bond yields to reach 7.40% (current: 7.70%) by the same time. However, in the second half of the year we expect markets to develop some risk premia as the inflation trajectory is expected to rise.

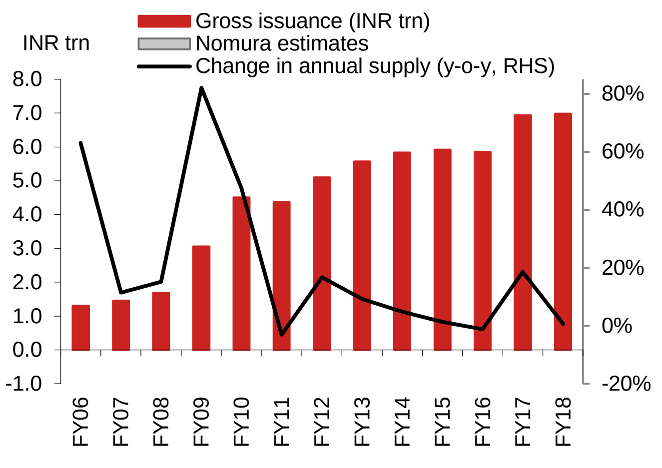
In bonds, the market would still need to navigate supply pressures which will likely weigh on markets intermittently and keep the spread versus 1yr T-Bill rate above 40bp during periods of heavy supply, while it compresses to below 40bp in periods of lower net supply. Our economics team expects the government to choose a slower pace of fiscal consolidation for FY17, which would have the obvious implications of increased bond supply. For a 3.6% fiscal deficit, net supply would be INR4.7trn,[12] higher than the INR4.5trn for FY16. However, with redemptions of about INR2.23trn, gross supply should be INR6.9trn (FY16: INR5.9trn, Figure 83). This approximately 17% increase in gross supply should weigh on the market intermittently. We recommend IGB 8.40% 2024, which we expect to perform well in Q1 2016. However, investors should switch to 5yr bonds in late February/early March as supply prone zone of 9yr-15yr part of the curve is expected to underperform ahead of supply in April-June period.

As far as the swap curve is concerned, we expect a range-bound market in Q1 2016 with 5yr NDOIS in the 6.50-7.00% range (Figure 84). Given stable monetary policy, we

[12] We assume nominal GDP growth of 11.5% and 85% of the fiscal deficit to be financed by bond issuance.

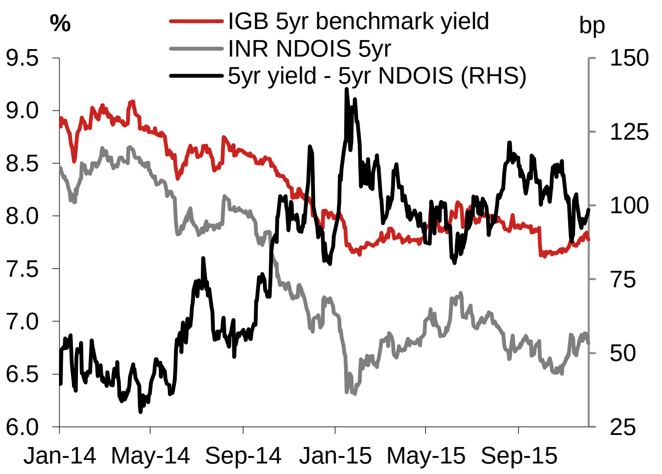
expect the swap curve to stay in bull flattening/bear steepening mode (see *Asia Insights - India: RBI in wait-and-watch mode*, 01 December 2015). With the front end of the swap curve pricing in approximately 20bp of cuts in one year's time, we see value in staying with INR 2s5s NDOIS and INR 1s5s flatteners, which is a positive carry way of expressing our receive view. We also note that current liquidity deficit conditions in the banking system, combined with OMO purchases, which are likely until March, are expected to put flattening pressure on the yield curve into Q1 2016 (see *Asia Insights - India rates: RBI infuses liquidity via OMO purchases and variable rate repo auctions*, December 03 2016). However, we note that towards the second half of the year the belly of the curve (5yr NDOIS) should start commanding risk premia. We note that the 5yr NDOIS touched 6.30% in January 2015 and 6.50% in October 2015. On both these occasions, the market's reaction was a result of the RBI surprising on the dovish side. In January, the RBI unexpectedly delivered an inter-meeting cut, and in October it delivered a bigger-than-expected cut. However, with 125bp of cuts already delivered and the risk of further dovish surprises low, in our view, we doubt that 5yr NDOIS will fall below the 6.50% level. Therefore, we look to exit our receive bias when 5yr NDOIS approaches the 6.50-6.60% zone. We expect 5yr NDOIS to outperform bonds as it moves towards 6.50-6.60% levels. However, when the NDOIS is lower, which should coincide with a wider 5yr bond vs NDOIS spread, we suggest investors initiate long 5yr bond vs 5yr NDOIS positions. We look to enter a long 5yr bond vs NDOIS position when the spread is closer to 110bp (currently 100bp) looking for a move to 60-70bp.

Fig. 83: Annual gross supply



Note: FY17 and FY18 numbers are Nomura estimates
Source: Nomura, RBI

Fig. 84: INR NDOIS 5yr and 5yr generic bond yield

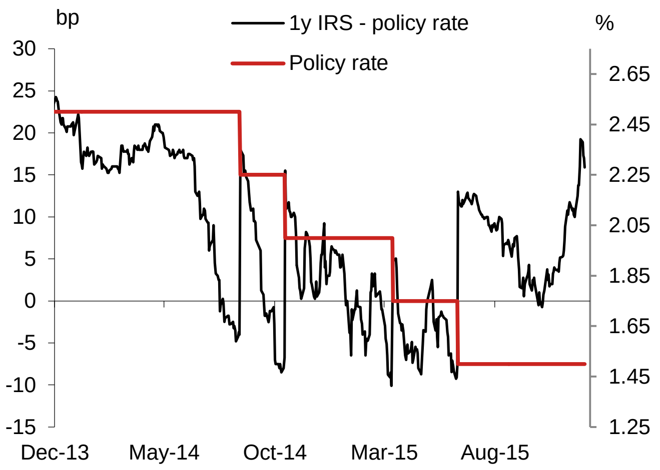


Source: Nomura, Bloomberg

Korea: Steepener and receive front-end bias

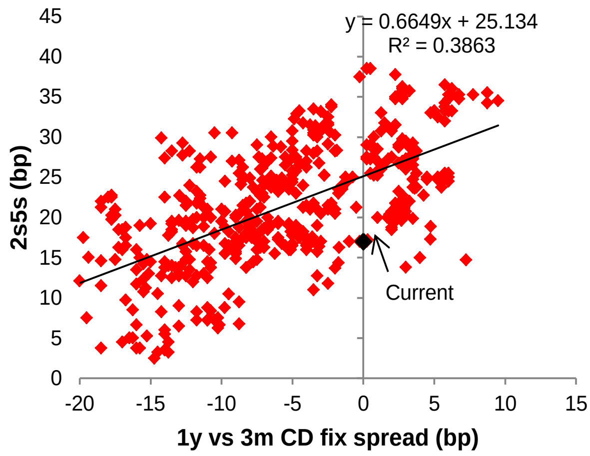
We recommend IRS steepeners (2s5s and 3s10s, see *Korea rates: Add 3s10s IRS steepener*, 27 November 2015) and look to receive 1y IRS into 2016. The market is effectively pricing the BOK to stay on hold in 2016 (see Korea: Rate-cutting cycle is not over yet) and the spread between the CD fix and policy rate to stay higher than in 2015 (Figure 85). This contrasts sharply with our house view of two 25bp rate cuts by June 2016. However, there is a risk that CD fixing may only fall back in January. On the rationale for steepeners, apart from expectation of CD rate to move back down, a regression of 2s5s versus the 1y – 3m CD fixing spread shows that both 2s5s and 3s10s are about 10bp too flat (Figure 86). If the market pricing turns out to be correct on the front-end and the BOK leaves the policy rate unchanged, a higher term premium would need to be built into the Korea curve as the Fed hikes.

Fig. 85: 1yr IRS vs policy rate spread (bp)



Source: Nomura, Bloomberg.

Fig. 86: Korea 2s5s IRS (bp) vs 1y - 3m CD fix spread (bp)



Source: Nomura, Bloomberg.

On bonds, supply and demand dynamics are favourable. Against this backdrop of stable bond supply in 2016 (compared with 2015), we expect lifer and pension fund demand to continue to support long-end KTBs. Specifically, lifers need to gradually increase duration to comply with changes in the International Financial Reporting Standard (IFRS4) to be effective early 2020. We believe the supply of high-quality long-tenor bonds will remain limited. However, there is some chance of risk premium increasing in December. Hence we wait for a level of 2.35-2.40% to go long 10yr KTBs (current 2.25%), as we believe these can ultimately test 2.00% as the BOK cuts.

Taiwan: Long duration bias but wait for better valuations

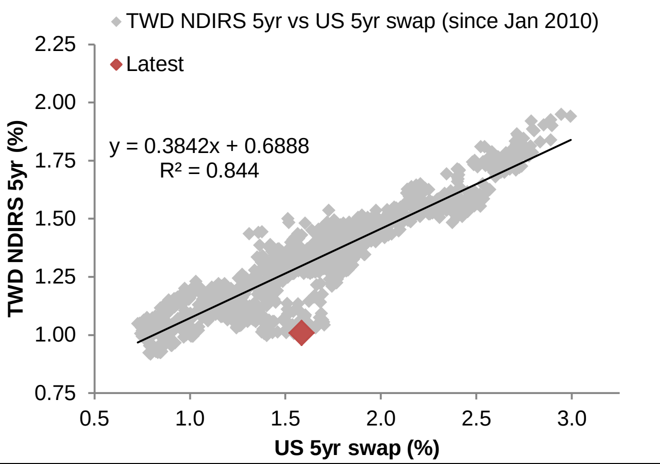
While we continue to hold a receive 2yr IRS trade into the December MPC, where we expect a 12.5bp cut, room for further cuts in rates in Q1 2016 looks limited, in our view. Market focus is likely to be on the presidential election in January (see Asia FX: Harvesting the rough seas). From a macro perspective, similar to China and Korea, we expect 2016 to be another year of below-potential growth in Taiwan. The combination of flush banking system liquidity (as loan growth slows) and strong demand by lifers should also support TGBs and, indirectly, IRS. The issue is stretched valuations. On a beta-adjusted basis, Taiwan 5yr IRS is about 20-25bp rich relative to US 5yr IRS (Figure 87). With monetary policies diverging in the US and Taiwan, it is reasonable for Taiwan rates to trade rich, but 20-25bp looks excessive. We wait for better levels and the conclusion of the presidential election before considering a more medium-term strategy trade for 2016.

HK: Pay 10y IRS and 2s5s steepener

With a Fed hiking cycle expected, 2016 should offer several HK versus US relative value trade opportunities. We recommend pay 10y HK IRS (see *First Insights - Hong Kong rates: Scale in pay 10y IRS*, 2 December, 2015) as the market is already discounting a gradual Fed hike cycle with the terminal fed funds rate not too far from our US economics team's forecast of around 2%. Paying HK rates is a cheap hedge against potential liquidity tightening as the Fed hikes. It also offers an opportunity to position for a convergence with CNH or CNY rates from time to time. As we highlight in Box 3: Thinking outside the box, the HKD peg could face its most trying time since being put in place in 1983. The key reason being that Hong Kong's economy is increasingly tied to China, which we believe will continue to make progress to internationalise the RMB and further liberalise its capital account

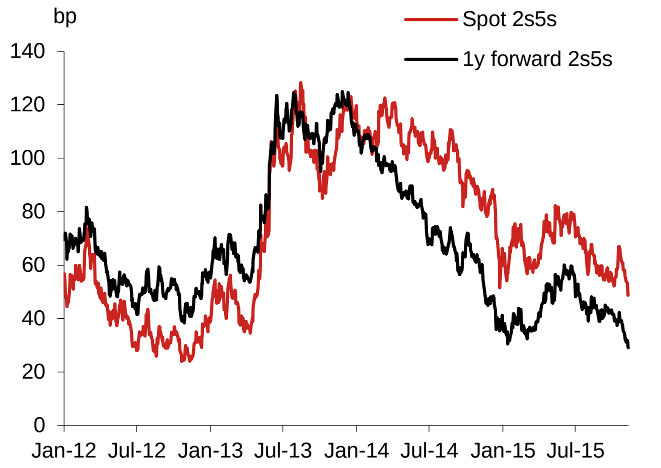
Separately, we hold a 2s5s HK IRS steepener (see *HK rates: Adding to our 2s5s IRS steepener*, 23 November 2015), targeting a move to 75bp including carry and roll, which is currently worth 7bp over three months (Figure 88). We expect front-end HK rates to outperform the US. Flush HKD liquidity – aggregate interbank balance of HKD400bn – should cause HK HIBOR to rise by less than US LIBOR in the initial stage of Fed hike.

Fig. 87: TWD NDIRS 5yr vs US 5yr swap



Source: Nomura, Bloomberg

Fig. 88: Spot and 1y forward 2s5s HK IRS spread (bp)



Source: Nomura, Bloomberg

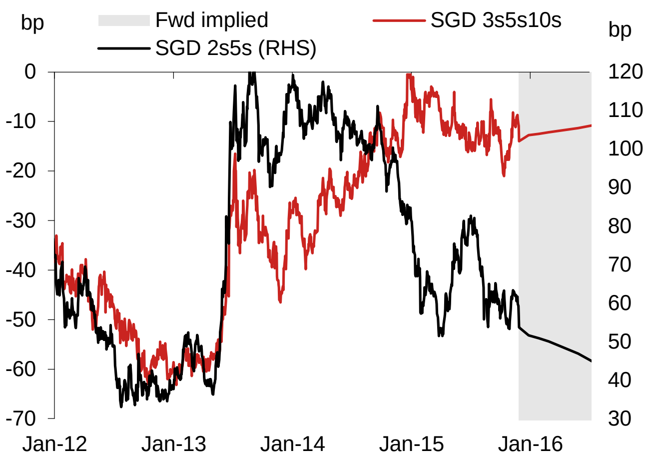
Singapore: Higher term-funding rate but fall in term structure

We continue to like flatteners in Singapore (Figure 89). Our flattening view is primarily derived from our belief that higher term funding rates are the new norm in Singapore (see *Asia Special Report - Singapore's productivity conundrum*, 23 October 2015). Also, with the MAS expected to remain on hold (see Asia FX: Harvesting the rough seas), we expect flatteners to be supported by a fall in the term structure of interest rates (Figure 90).

As far as front-end rates are concerned, they have risen along with six-month implied fixings since mid-October. We believe this was initially in response to the MAS policy in which the rate of S$NEER policy band appreciation was “reduced slightly”. We think the shallower slope should keep term funding rates elevated (see *Singapore: MAS eases FX policy slightly*, 14 October 2015). Indeed, reduced FX carry (in the form of a shallower slope) calls for a higher equilibrium value of term funding rates and one closer to the interest rates of Singapore’s major trading partners. We expect SOR fixings to stabilise closer to current levels. However, as fixings stabilise, we should see compression of spreads between the belly (which should reflect the expectations on the future path of fixings) and fixings itself. This should support a further flattening of the curve.

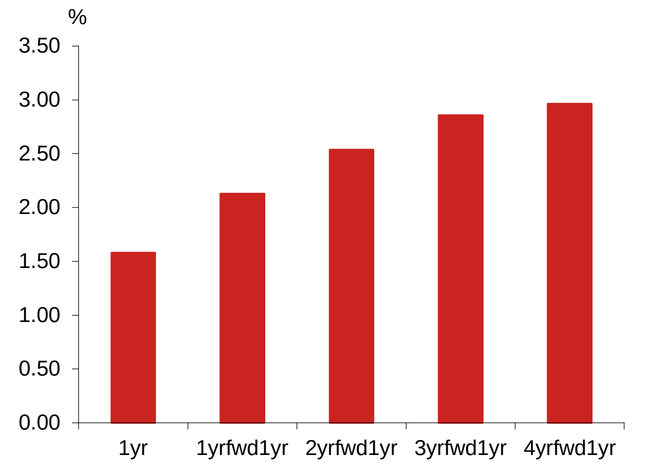
As far as specific trade recommendations are concerned, we remain comfortable receiving 2s5s flatteners and receiving 3s5s10s. We look to increase our receive SGD 3s5s10s position should the fly cheapen. Our choice of receiving in the 5yr part of the curve, or belly outperformance, is primarily because we expect 1) term-funding rates to remain elevated, which will limit the 2s5s/3s5s bull-steepening potential, 2) Fed hikes to be gradual, limiting the scope of 2s5s/3s5s bear steepening, and 3) the 5s10s flattening pace to slow, as term premiums are already compressed after the major flattening observed in 2014 which, in our view, was a result of ECB and BOJ QE operations. Although we do not expect term premiums to rise, we believe it will become incrementally less likely to see a 2014-style flattening led by 5s10s.

Fig. 89: SGD IRS 2s5s and 3s5s10s



Source: Nomura, Bloomberg

Fig. 90: Term structure of SGD IRS curve

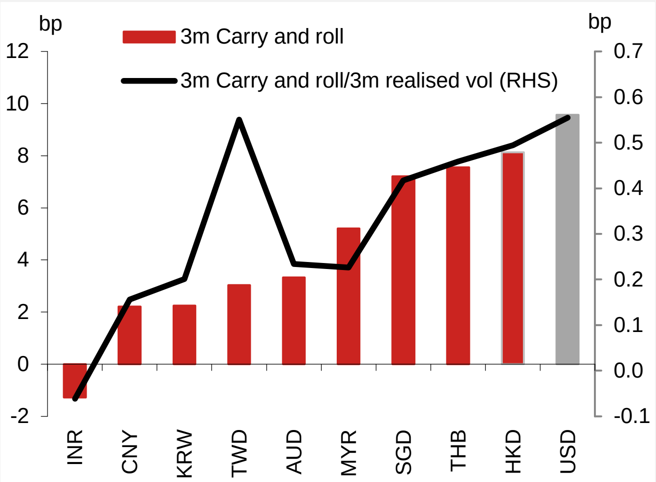


Source: Nomura, Bloomberg

Box 12: Swap valuations

The carry and roll in the 5yr part of Asia swap curves indicates that the dollar proxies (i.e. Singapore and Hong Kong) along with Thailand are most attractive. However, adjusting for the realized volatility over the past three months makes Taiwan much more attractive than other Asia curves. With regards to the pricing in of fixing changes implied by swap curves, we note that Australia, China, India and Taiwan are pricing a move lower in fixings over the next 12 months.

Fig. 91: Carry roll profile in Asia 5yr swaps



Source: Nomura, Bloomberg

Fig. 92: Interest rate valuations (fixing changes priced in swap curves)

	3m	6m	12m	18m	24m
	(bp)	(bp)	(bp)	(bp)	(bp)
AUD	-14	-20	-27	-27	-28
CNY	-2	-17	-25	-24	-13
INR	-1	-1	-20	-19	-18
MYR	4	7	11	16	23
KRW	-2	-4	-4	-3	2
TWD	-4	-7	-11	-13	-6
THB	-4	-6	-1	6	13

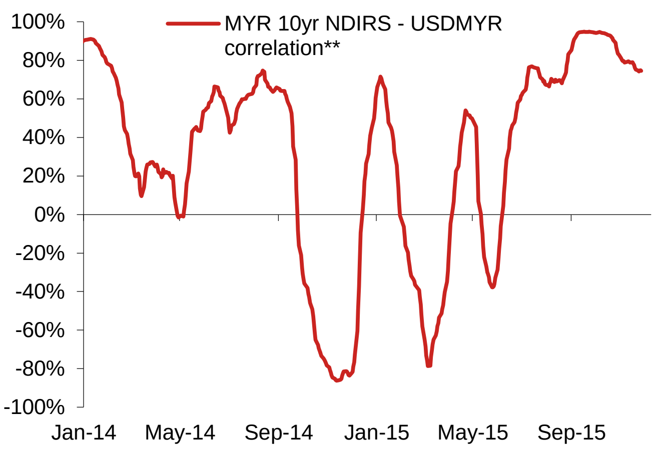
Note: Interest rate valuations based on fixing rate changes priced in the offshore swap curve; the reference fixings are as follows: Australia (3m bank bill), China (3m 7d repo IRS), India (3m MIBOR NDOIS), Malaysia (3m Klibor), Korea (3m CD), Taiwan (3m CP) and Thailand (6m FX implied); The interest rate valuation for India are adjusted for the rise in fixings during the financial year-end. Source: Nomura, Bloomberg

Malaysia – Carry in front end, curve to steepen

We recommend accumulating receivers in the front end of the Malaysia swap curve, along with steepeners (see *Malaysia rates: Increase steepening exposure in MYR NDIRS*, 5 November 2015). Malaysia swap rates have faced upward pressure since August, consistent with their increased correlation with FX markets (Figure 91). We believe this was primarily due to the market's perception that BNM may hike rates in order to defend MYR, but these expectations were never realised. Instead, we expect monetary policy to remain stable into 2016. Our economics team, Euben Paracuelles and Brian Tan, expects headline inflation to rise in Q1 2016 to 5.1% and average 4% in 2016. However, they expect BNM to look through this higher inflation – which is a result of base effects and subsidy cuts, and expect core inflation to remain broadly stable, which would support this view (see Asean-5: Muddling through). Another important consideration for policymakers is a further deceleration in growth. Our economics team forecasts a moderation of GDP growth to 4% in 2016 from 5% in 2015.

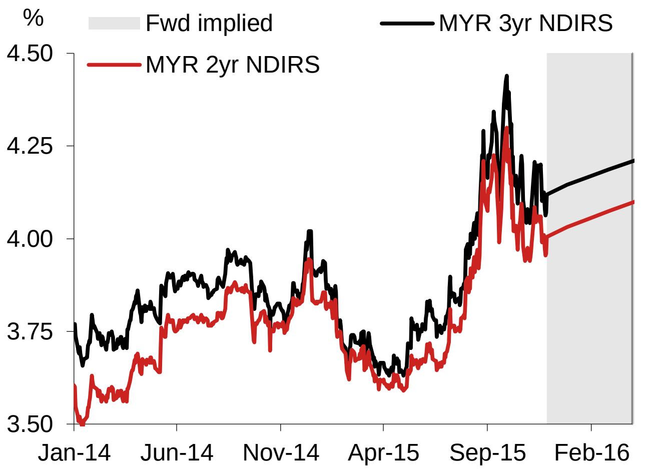
On valuations, we feel Malaysia rates offer decent carry at current levels (see Box 12: Swap valuations). For example, we note that, even after the fall in front-end rates since mid-October, the market is pricing in one hike and two hikes in one and two years, respectively. As such, we think investors should look to accumulate receivers in the 2yr and 3yr part of the curve (Figure 94) as and when the opportunity arises. We look to accumulate receivers closer to 4.10% in 2yr and 4.20% in 3yr. In terms of carry, after Singapore and Hong Kong, Malaysia front-end rates offer the most carry in Asia ex-Japan (Figure 95).

Fig. 93: Correlation between FX and rates



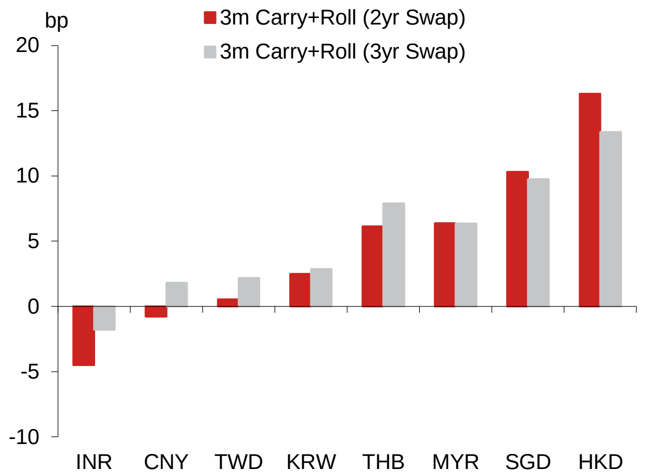
Source: Nomura, Bloomberg

Fig. 94: MYR NDIRS 2yr and 3yr



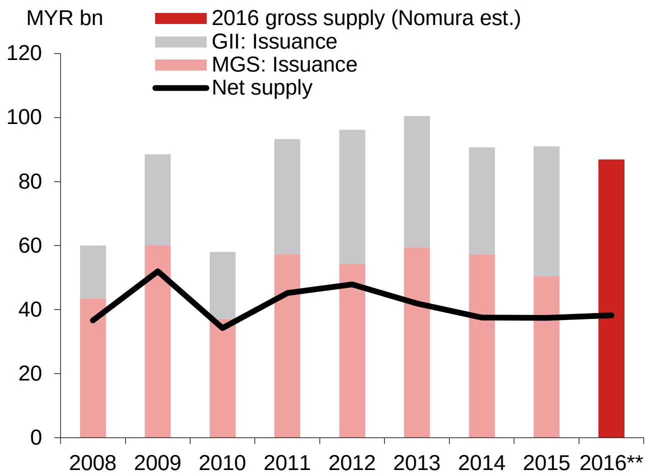
Source: Nomura, Bloomberg

Fig. 95: Carry and roll in front end of Asia swaps



Source: Nomura, Bloomberg

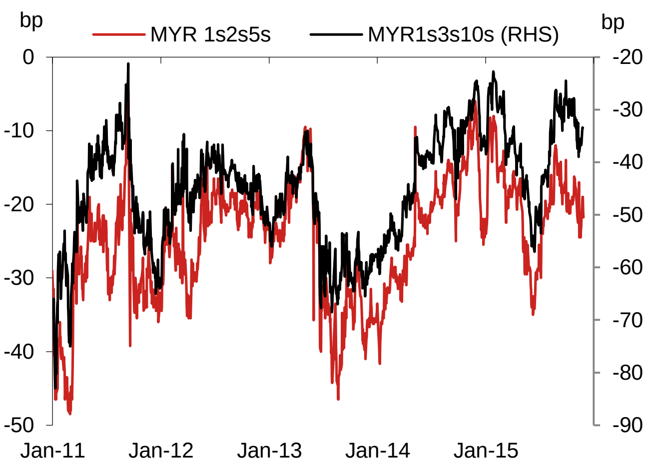
Fig. 96: Malaysia: gross and net supply



Source: Nomura, Bondinfo

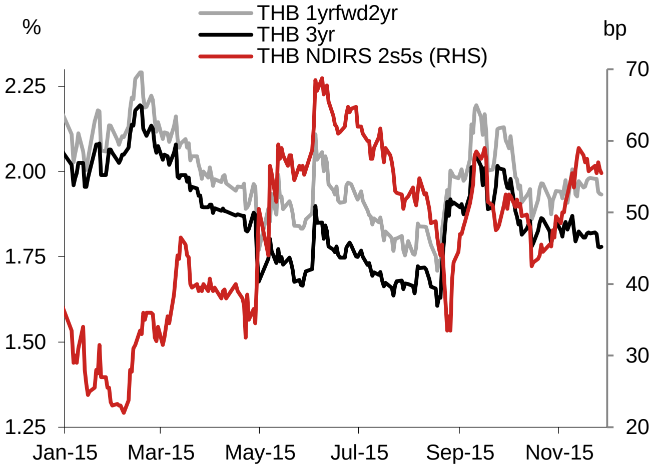
That said, we still like steepeners in the Malaysia curve. Along with stable and lower front-end rates, our steepening view also stems from our belief that the small reduction in gross bond supply (MYR86bn in 2016 vs MYR91bn in 2015, on our estimates; Figure 96) will weigh on bond markets. Importantly, net bond supply is rising due to lower redemptions. We like expressing this view through 1s3s10s and 1s2s5s, which are proxy 3s10s and 2s5s steepeners (Figure 97) and offer a relative value advantage (see *Asia Insights - Malaysia rates: Steepening pressure likely to emerge*, 29 October 2015).

Fig. 97: MYR NDIRS 1s2s5s and 1s3s5s



Source: Nomura, Bloomberg

Fig. 98: THB NDIRS 1yrfwd2yr, 3yr and 2s5s

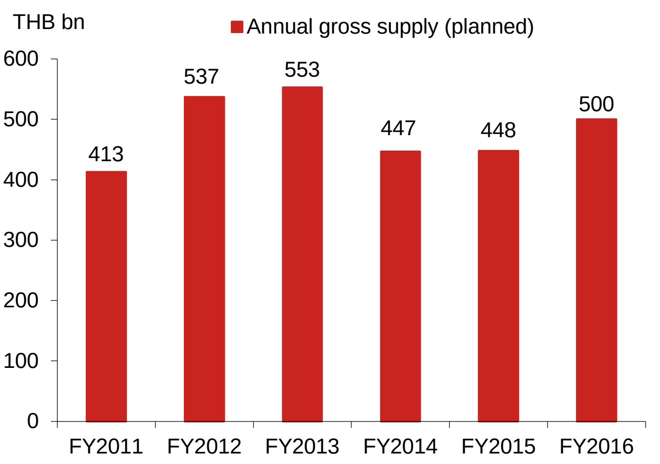


Source: Nomura, Bloomberg

Thailand – Front-end receivers and steepeners

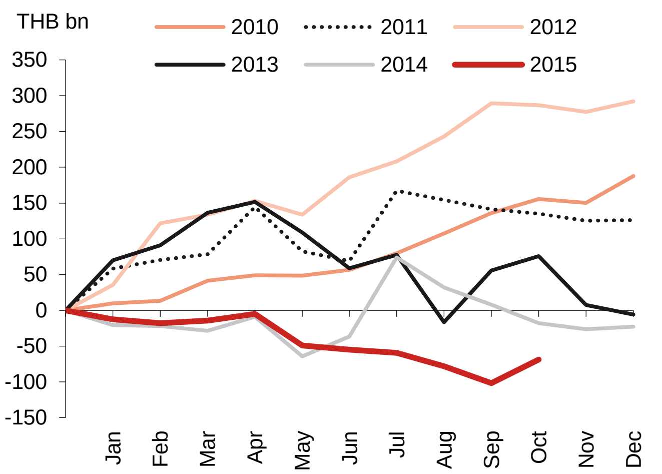
We recommend a combination of front-end receivers and steepeners. Our economists forecast a cumulative 50bp of easing from the BOT in H1 2016 (see Asean-5: Muddling through). We believe lower and stable fixings, along with monetary easing expectation, will keep front-end rates under receiving pressure (see *Thailand: BOT still on hold but case for easing intact*, 4 November 2015). Indeed, growth is likely to remain subdued, with our economists forecasting 2016 GDP growth of 2.5% versus 2.7% in 2015 and well below official projections. We expect inflation to pick up, but it should remain at the lower end of the 1-4% target band. We also continue to like curve steepeners in Thailand, as we believe bond supply will weigh on the longer end of the curve. There is THB500bn of ThaiGB supply (LB + ILB + Amortized bonds) scheduled for this fiscal year (FY16: October 2015 to September 2016) versus THB448bn last fiscal year (i.e., an increase of 12% y-o-y; Figure 99). This will likely weigh on markets. The quarterly profile of supply suggests that supply pressure is likely to increase from 2016, as there are limited redemptions over the rest of the financial year.[13] We also like steepeners because we expect foreign investor interest to remain subdued. Year to date, there have been net outflows of THB69bn, which constitutes one of the worst years for flows in recent times (see Box 13: Asia debt flows in 2015). We do not expect a significant turn-around of foreign investor interest in the Thai debt market (Figure 20).

Fig. 99: Annual gross supply



Source: Nomura, Bloomberg

Fig. 100: Yearly flows in Thailand debt



Source: Nomura, CEIC, Bank of Thailand

13 There are only two redemptions in the rest of FY16 (ends Sep): THB29bn in May and THB52bn in July.

Indonesia – Underweight to neutral

In Indonesia, we recommend turning neutral from an underweight stance, as we expect a significant fall in inflation to lead to a rise in real yields. The prospect of inflation falling to within Bank Indonesia's policy target range of 3-5% also provides scope for policy easing.

Our economics team has recently become more constructive on Indonesia on the prospects of more stimulatory fiscal and monetary policies, as well as reform measures (see *Asia Special Report - Indonesia: Silver linings*, 25 November 2015). On monetary policy, our economists expect BI to cut its policy rate by 25bp in January and look for a further 25bp cut in Q1 2016. This should be supported by a significant fall in inflation from an average of 6.4% in 2015 to 4.7% in 2016 (see Asean-5: Muddling through). Assuming this sharp fall in inflation, Indonesia bond yields would offer the highest real yield in Asia.

We forecast a fiscal deficit of 2.6% of GDP in 2016 versus 2.5% of GDP in 2015. However, net government bond supply is expected to rise by 3.6% from IDR353.3trn to IDR366.2trn in 2016 (Figure). Gross issuance is expected to be IDR530trn in 2016, up 15% from 2015. We view this as a moderate increase that can be easily absorbed by the market.

Overall, the attractive real yields, monetary easing expectations and manageable bond supply have led us to change our stance from underweight to neutral on Indonesia government bonds.

Australia – Buy dips at the front end of the curve

Our below-consensus growth view and expectation that the RBA will likely need to lower the cash rate again (in February, with the risk of a later move) leads us to favour a relatively constructive, dip-buying approach. We currently favour a 3-month forward 1s3s flattener. This trade captures our low-for-long theme on rates – at the front part of the curve – and offers attractive roll (see *Trade Update*, 23 October 2015), while seeking to minimise the impact of potential moves in US bond yields. We also look for opportunities to initiate curve steepening and cross-market, spread-compression trades, particularly against US bonds.

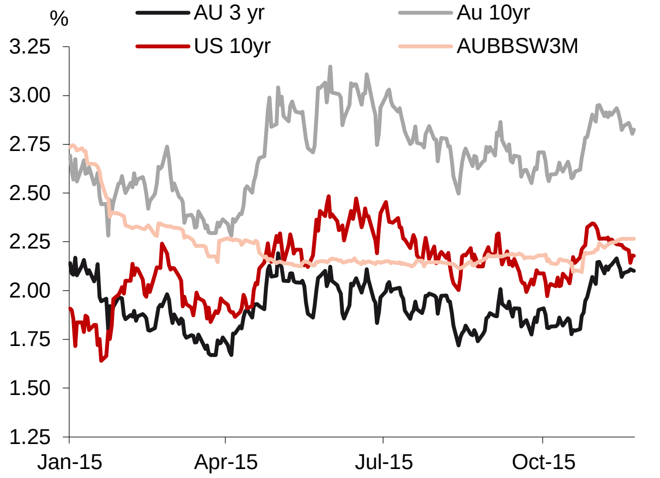
In our view, Australian rates markets were largely driven by two sets of factors in 2015: 1) underwhelming domestic and regional growth (including in China) and subsequent expectations regarding – and actions undertaken by – the RBA, and 2) the US bond market and the Federal Reserve. As we entered 2015, slowly building expectations for a rate cut led to a decline in yields across the curve (Figure 101). The RBA managed to surprise much of the market with the timing of its two 25bp cash rate cuts in February and May, and further surprised by holding off on further moves over the balance of the year. This lack of policy action towards the end of 2015 led to a rise in yields across the curve. The market is currently pricing in 15bp of easing by the third quarter of 2016 (Figure 102), although a majority of local economists forecast no further cuts to Australia's 2% cash rate.

In 2016, we expect Australian rates to again be heavily influenced by the Fed and the subsequent reaction to Fed action by US bonds and other markets. Our house view is Fed lift-off this month, with the Fed clearly signalling a "gradual" tightening profile, in line with our forecasts of the next Fed hike not until June 2016, followed by one more in Q4. Our central case is that US bond yields will be modestly higher by mid-2016.

While Australian bond yields are highly correlated with US yields, the front part of the curve is, naturally, more influenced by domestic and regional factors. This should come as no surprise, as the Australian economy has become increasingly integrated into the regional economy; most of Australia's major export markets destinations are within the region, led by (and in order) China, Japan and South Korea.

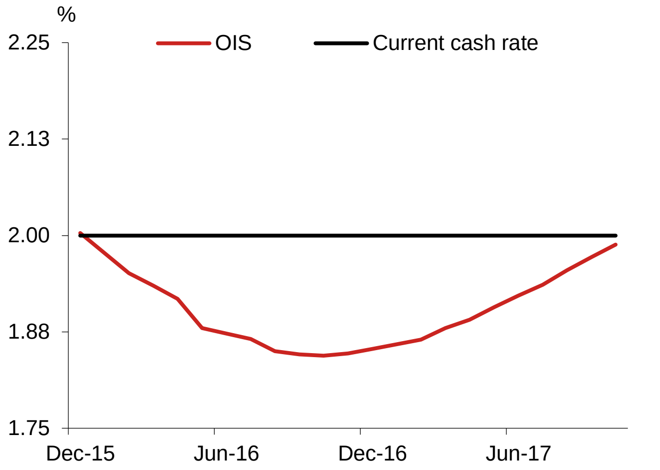
Our below-consensus growth view and expectation that the cash rate will likely be lowered in 2016 lead us to favour a buy-on-dips approach, particularly in the front half of the yield curve. We are also struck by the differing expected monetary policy paths between the RBA and the Fed. We think this supports yield curve steepening strategies in Australia, perhaps spread against yield curve flattening strategies in the US.

Fig. 101: Australian and US yields



Source: Nomura, Bloomberg

Fig. 102: Cash rate expectations



Source: Nomura, Bloomberg

We also expect an increase in the Commonwealth's funding task to be announced before Christmas, following the release of the annual Mid-Year Economic and Fiscal Outlook, and reflecting likely reductions of official real GDP and inflation forecasts. While we do not believe that this could be enough to threaten Australia's prized AAA rating, additional supply, which may continue to be tailored towards the longer end of the curve, could also add modestly to local steepening pressure.

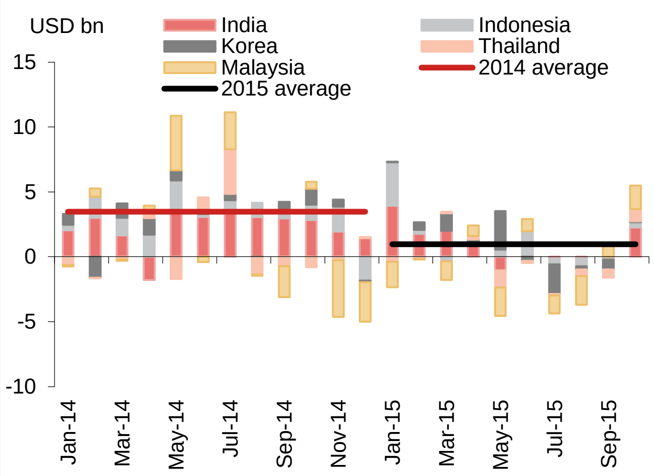
While Commonwealth bond supply will continue to rise over the coming year, we expect semi-government net issuance to be far more modest. We also note the recent very successful long-term lease of NSW's electricity transmission network, Transgrid, which will see the volume of NSWTC bonds on issue decline. We continue to advocate accumulation of semi-government bonds over Commonwealth bonds when spreads widen.

Australian bond-swap spreads have narrowed aggressively over recent months, following trends in US and other rate markets. Consistent with our house view for some re-widening of these spreads in the US as we move into 2016 (see *US Rates Insights*, 10 November), we believe there could be a similar move in Australia.

Box 13: Asia debt flows in 2015

Compared with 2014, 2015 has been a weak year for flows in Asia debt markets.[14] Average monthly inflows in Asian markets fell from USD3.5bn to USD1bn this year (Figure 26). The monthly flows show that the flow picture deteriorated as the year progressed, especially in Q3 – which was the first quarter in which Asia markets experienced outflows on an aggregate basis since the taper tantrum outflows. We note that the slowdown in flows from 2014 has been across markets. With regard to the quantum of inflows, India and Indonesia lead the pack, while Malaysia has experienced the most outflows (Figure 27).

Fig. 103: Monthly flows in Asia debt markets



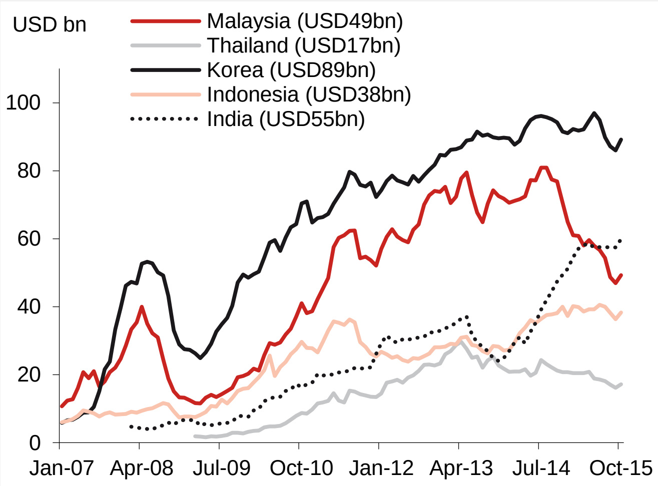
Source: Nomura, Bloomberg, CEIC, NSDL, BOT, BNM, BI, BOK

Fig. 104: Flows in Asia debt markets: 2014 vs 2015

		2014		2015 (YTD)	
(USD bn)	*As of*	Total flows	Monthly avg	Total flows	Monthly avg
India	*30-Nov-15*	27.3	2.3	8.9	0.8
Indonesia	*25-Nov-15*	11.6	1.0	6.1	0.6
Korea	*31-Oct-15*	5.4	0.5	1.6	0.2
Thailand	*31-Oct-15*	-0.7	-0.1	-2.0	-0.2
Malaysia	*31-Oct-15*	-1.9	-0.2	-4.7	-0.5

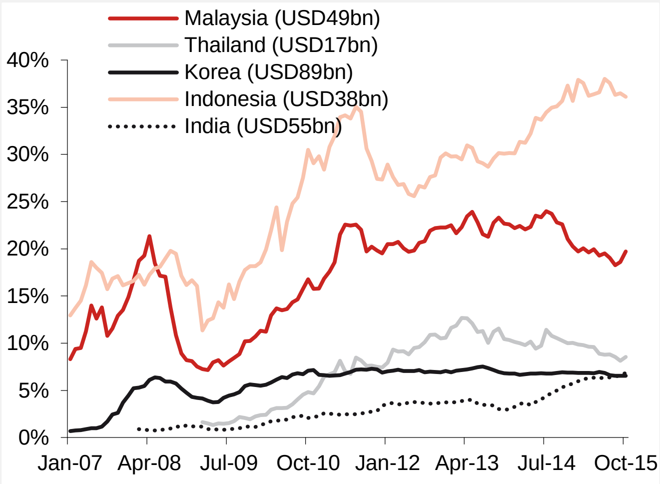
Source: Nomura, Bloomberg, CEIC, NSDL, BOT, BNM, BI, BOK

Fig. 105: Foreign holdings of debt securities (USD bn)



Note: Debt securities in Malaysia, Korea and India include all government, central bank and corporate debt; for Thailand and Indonesia it includes all government and central bank bills. Data are as of end-October
Source: Nomura, Bloomberg, CEIC

Fig. 106: Foreign holdings of debt securities (% of outstanding)



Note: Debt securities in Malaysia, Korea and India include all government, central bank and corporate debt; for Thailand and Indonesia it includes all government and central bank bills. Data are as of end-October
Source: Nomura, Bloomberg, CEIC

[14] Based on data as of end-Oct for Malaysia, Korea and Thailand, end-Nov for India and 25 Nov for Indonesia.

Equity strategy: Stay with cyclicals, but reduce leverage and beta

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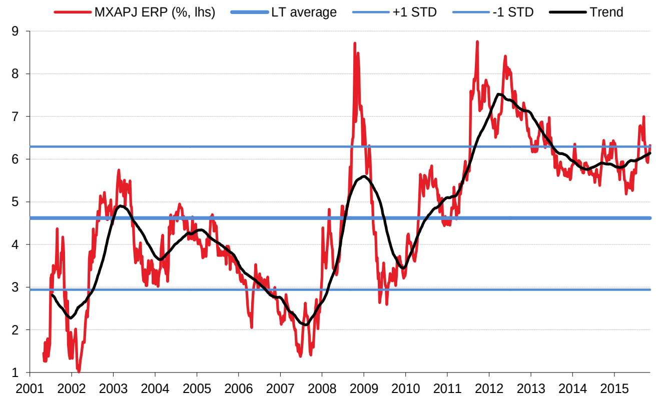
For Asia ex-Japan stocks in 2016, many of the past year's key macro drivers will remain center-screen: China's moderating growth (especially in the resources-intensive *investment* component of GDP), a shallow ongoing pickup in global Nominal GDP led by the Developed Markets rather than Emerging Markets, anticipation of rising US interest rates, US dollar gains, and a heavy energy- and commodity-price environment will all *remain* influential drivers of risk and opportunity for the equity asset class, in our view. Thus many of our key preferences by Asia-Pacific country and sector also remain unchanged as we round the bend into 2016 — namely an emphasis on capital-abundant, cyclically sensitive, low-yielding and/or downstream plays at the expense of capital-poor, low-cyclical, high-yield and/or upstream ones (see recommended country and sector allocations in Figure 121 on page 79).

The fundamental crosscurrents described in previous sections of this report will continue to present portfolio managers with distinct challenges. On one hand, the regional equity risk premium is once again elevated (at roughly 1.0 standard deviations above long-term mean – Figure 107) and equity cross-correlations have traced back toward GFC-era peaks (Figure 108) – both suggesting the *potential*, at least, for stocks to stage a respectable valuation-led rally in 2016 if headwinds ease. Yet the persistence of (US rate-driven) capital-outflow risks and related Asia-Pacific FX volatility, as well as of China growth uncertainties and risk of credit events, could impede the *capture* of regional value even *if* actual outflow/volatility *episodes* in 2016 are only intermittent and China's slowdown ultimately unfolds in a generally orderly fashion.

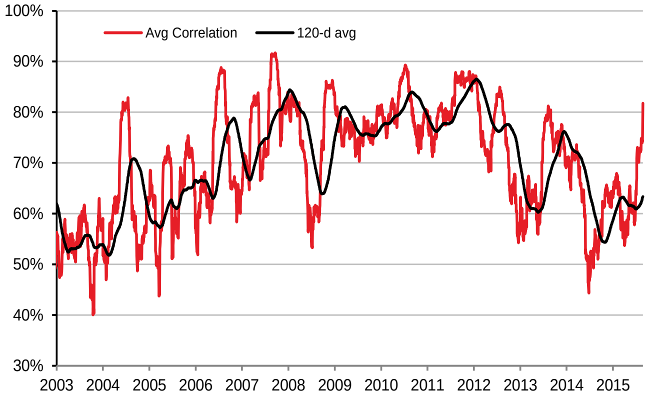
Fig. 107: MSCI Asia-Pacific ex-Japan: Equity risk premium

Consensus forward earnings yield less 10-yr US Treasury yield



Source: Bloomberg, Datastream, Nomura Strategy

Fig. 108: MSCI Asia-Pacific ex-Japan: Average pair-wise correlation of 10 sectors



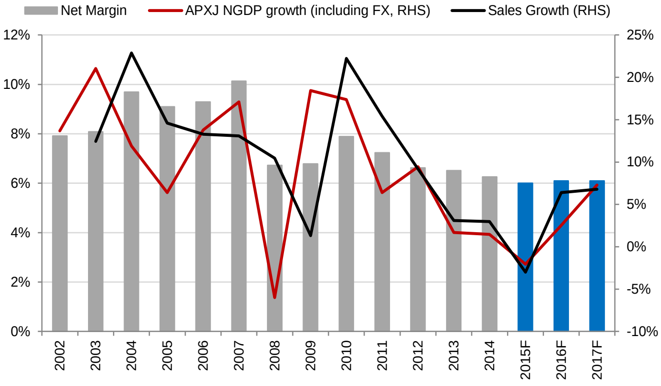
Source: Bloomberg, Nomura Strategy

A fairly adverse environment for *value*-capture suggests equities' attractions will continue to hinge predominantly on the outlook for *growth*. But here we find at least modest ground for encouragement: Our house baseline economic forecasts still point to enough global and (in pockets) regional demand growth in the year ahead — particularly in *nominal* terms (where corporate revenues occur) – for us to expect 6.4% Asia-Pacific ex-Japan wide Sales growth in 2016, and 6.8% in 2017 (Figure 109). With a small (~0.2ppt) improvement in the region-wide Net Income margin over the next two years (to roughly 6.2% by 2017) from further pass-through of lower energy and commodity input costs as well as modest pricing power gains, this would produce regional EPS growth of roughly 7-8% in each of the next two years (i.e. slightly stronger than the consensus for ~6% in 2016). This would be driven more by EM Asia (at ~10%) than by Developed Asia-Pacific ex-Japan, where we expect more sluggish ~5% earnings growth.

A modest forward PER multiple expansion back to the regional long-term average of 12.4x from the current low-single digit discount (at 12.1x), we believe, could then deliver the **MSCI Asia-Pac ex-Japan benchmark to an end-2016 target of 465, or roughly 8% above our end-2015 assumption of 430** (Figure 110).

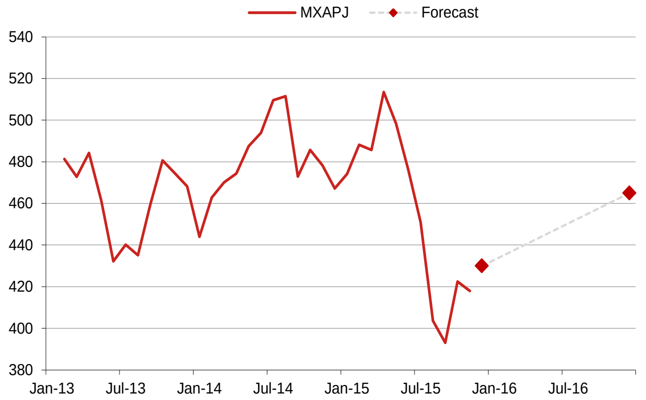
Fig. 109: MSCI Asia-Pac ex-Japan: GDP, Sales and margins

Nomura forecasts for 2015 and beyond



Source: Datastream, Nomura Global Economics, Nomura Strategy

Fig. 110: MSCI Asia-Pac ex-Japan Index & Nomura forecasts



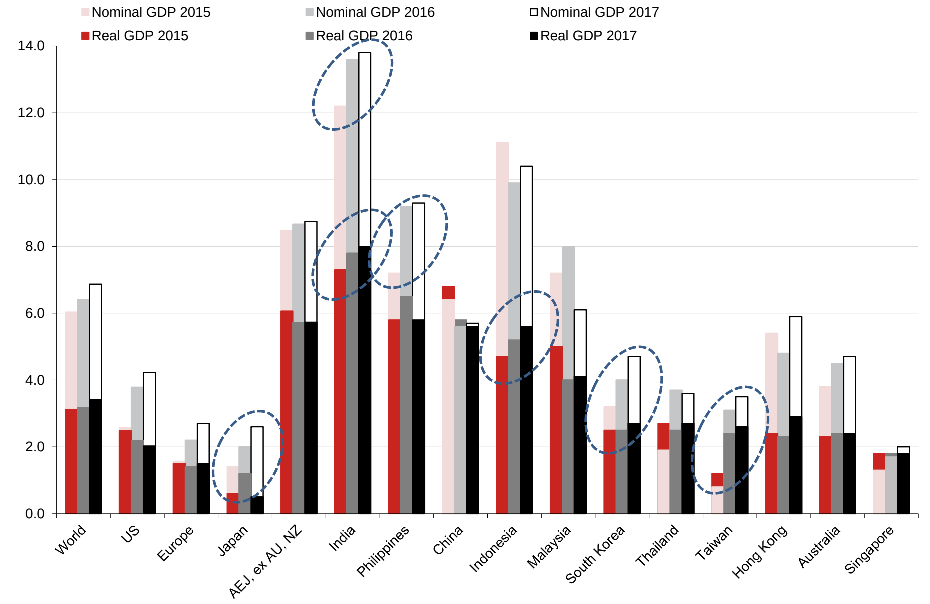
Source: Bloomberg, Nomura Strategy

Despite undeniable risks and structural drags discussed in this report, Asia ex-Japan offers a few comparative bright spots of cyclical demand pickups and/or improving pricing power in 2016 and into 2017 (Figure 111).

- Namely, as platforms for corporate revenue, Nomura Asia-Pacific Real or Nominal GDP growth forecasts suggest comparatively better year-on-year deltas in India, Taiwan, Korea, possibly Indonesia and the Philippines — and also Japan.
- Our house forecasts also feature reflationary recovery progress in both the US and Europe that allows both of those economies to post significant improvements in *Nominal* GDP growth in both 2016 and onward into 2017:

Fig. 111: Nomura DM and Asia-Pacific Real & Nominal GDP Growth Forecasts (2015-17)

y-y

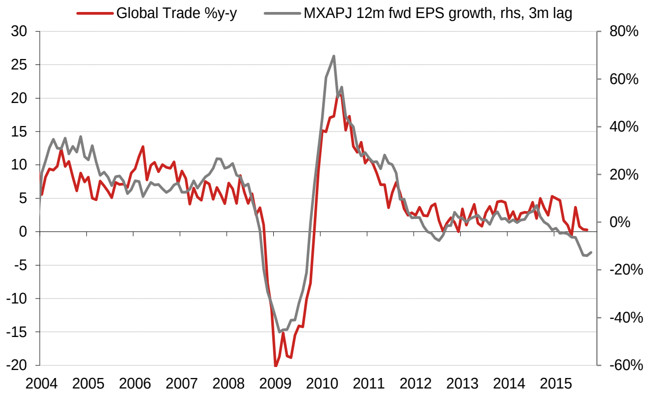


Sources: Nomura Global Economics

We note that Asia-Pacific ex-Japan corporate earnings growth remains largely leveraged to the global economy and is strongly correlated with the global trade cycle (Figure 112). Indeed, despite the prominence of "decoupling" narratives in recent years and investor focus on secular *domestic* consumption trends in the region, there remains a strong relationship between Asia-Pacific ex-Japan earnings and the OECD Global Leading Economic Index (Figure 113). Thus, as the global trade cycle even *gradually* picks up with DM demand (see Box 15: Rising sums: Japanese capital embracing AXJ), Asian earnings stand to gain disproportionately.

Fig. 112: Global trade vs APXJ consensus fwd EPS growth

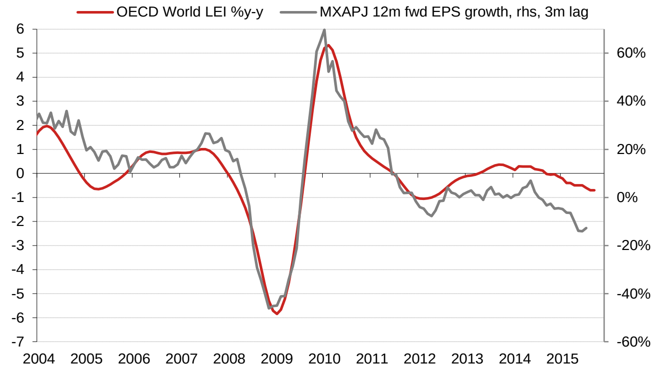
%y-y



Source: CPB, Bloomberg, Datastream, Nomura Strategy

Fig. 113: OECD Global Leading Economic Indicator vs APXJ consensus forward earnings growth

APXJ earnings are lagged by three months



Source: OECD, Bloomberg, Datastream, Nomura Strategy

Consensus 2016 earnings forecasts already point to stronger earnings growth in *some* of Asia's export-exposed sectors such as Industrials (23%), Discretionary (12%, a sector that in Asia contains a considerable amount of export-oriented capitalization, such as Autos) and Tech (8%), whereas earnings outlooks in some domestic/non-cyclical sectors appear less robust – e.g. Utilities (-14%), Telecoms (6%), Staples (6%), as well as Materials (-5%, a sector with considerable adverse linkage to China's rapidly slowing investment cycle).

Fig. 114: Asia-Pacific 2016 consensus EPS growth forecasts by Country & Sector

%y-y

	Japan	Asia-Pac ex-Japan	Australia	China	Hong Kong	India	Indonesia	Malaysia	Korea	Philippines	Singapore	Thailand	Taiwan
Index	7%	6%	-8%	7%	9%	19%	11%	8%	8%	12%	5%	12%	4%
Discretionary	12%	12%	9%	14%	6%	25%	14%	15%	11%	17%	6%	13%	11%
Staples	6%	6%	-8%	13%	-	18%	17%	30%	7%	18%	15%	23%	10%
Energy	52%	7%	-49%	16%	-	11%	-8%	12%	0%	-	-	14%	-5%
Financials	5%	5%	4%	3%	9%	18%	11%	7%	4%	15%	5%	10%	-2%
Banks	3%	5%	6%	3%	-2%	19%	12%	7%	2%	14%	4%	10%	5%
Property	7%	8%	-10%	9%	11%	34%	9%	-6%	-	15%	8%	17%	-23%
Healthcare	5%	19%	6%	18%	-	33%	14%	24%	86%	-	-	16%	-
Industrials	8%	23%	10%	10%	13%	29%	2%	6%	199%	11%	5%	11%	17%
Materials	12%	-5%	-40%	20%	-	45%	7%	14%	52%	-	-	9%	2%
Tech	10%	8%	-7%	46%	25%	12%	-	-	2%	-	-	11%	6%
Telecom	4%	6%	3%	5%	13%	5%	14%	7%	8%	1%	6%	16%	4%
Utilities	-29%	-14%	7%	5%	5%	18%	4%	0%	-52%	14%	-	7%	-

Note: MSCI indices in local currency, except regional aggregate in US$. *Japan earnings growth for fiscal year ending March 2017

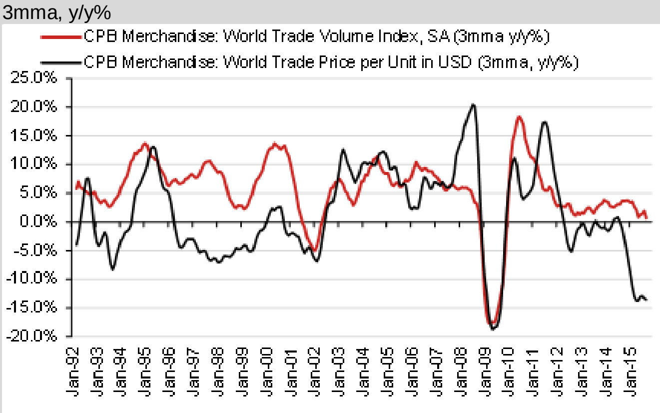
Source: Datastream, Nomura Strategy

Box 14: The uncomfortable wait for Asian export earnings

One notable headwind for Asian stocks in 2015 has been the absence of a meaningful merchandise trade recovery. To be circumspect, this has been in no small part a *nominal* phenomenon – i.e. caused by translation effects, given US dollar strength (which reduces the notional value of the non-dollar portion of aggregate global trade), as well as, more concretely, the substantial drop in global dollar-denominated energy and commodity prices since 2014 (Figure 115). Stripping out such price effects, *volume* growth in world merchandise trade volume has in fact been positive, if still lackluster at just +1.5% y-y YTD. Indeed, since the post-crisis rebound 'normalized' from mid-2011, y-y trade volume growth, at an average of 2.7%, has modestly *outpaced* global real GDP growth (of 2.3% on average over the same period). While respectable, this still represents a significant downshift from the average trade volume growth of nearly 7% over the 15 years prior to the GFC (more than double that period's average 3.1% global real GDP growth, Figure 116).

Fig. 115: World trade volume vs. unit price

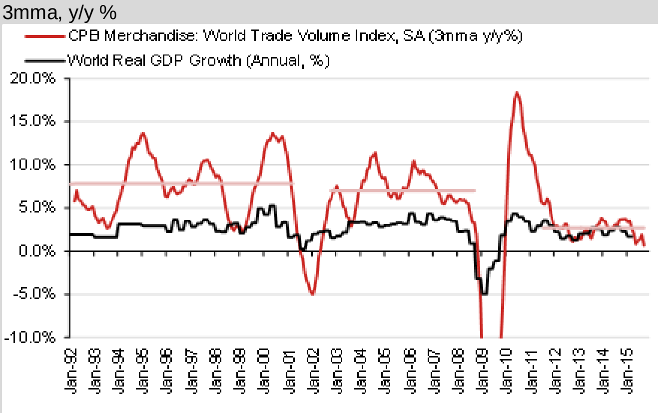
3mma, y/y%



Source: Bloomberg, Nomura Strategy

Fig. 116: World trade volume vs. world real GDP

3mma, y/y %



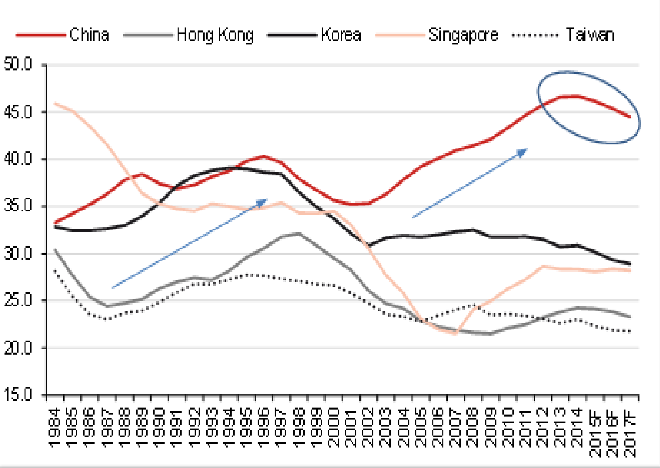
Source: Bloomberg, Nomura Strategy

The post-GFC moderation in world trade growth can partly be explained by *cyclical* headwinds, given the (demand-dampening) deleveraging process in both the household and corporate sectors of major global economies. But the tapering off of a number of previous *structural* tailwinds – largely related to the 'hypergloblization' from the 1990s onward, particularly post China's 2001 World Trade Organization entry – has also left a slower 'residual equilibrium' trade growth. These effects have included the following:

- Diminishing demand impulses from East Asia's industrialization: The rapid export-led industrialization among the Asian Tigers during mid-1980s through1990s and in China during the 2000s not only led to productivity gains that created a competitive advantage in manufacturing exports, but also created import demands for the build-out of manufacturing capacity (such as capital equipment and raw materials). Such tailwinds are inevitably slackening both as China's economy balances away from investment (Figure 117) and as East Asia's aging demography shifts consumption demand towards services and away from merchandise.
- This is also dampening trade gains as expansion of the global value-added supply chain asymptotically slows, suggested by the plateauing growth of intermediate goods imports globally since 2011, after being the *primary* driver of trade gains during the 2000s (Figure 118). This has come alongside anecdotal evidence, at least, of some re-onshoring of US manufacturing and import substitution by Chinese industries.

Fig. 117: Total investment as % of GDP

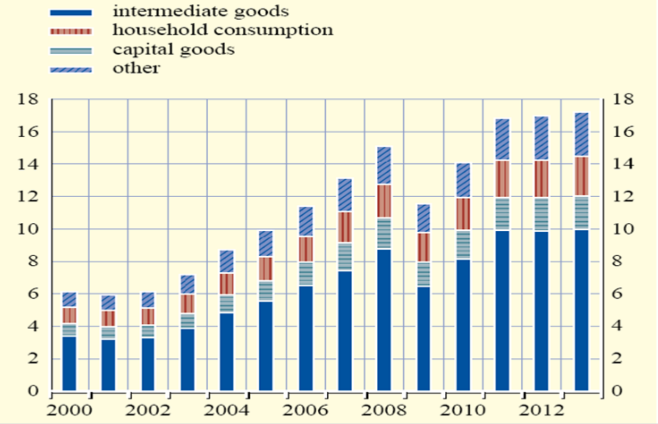
(current local currency, %)



Source: IMF, Nomura Strategy

Fig. 118: World imports of goods by end-use category

(trillions of current USD)



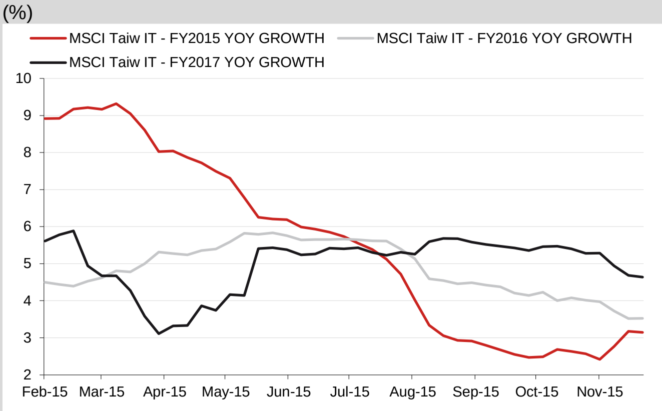
Sources: OECD STAN database and ECB staff calculations. Notes: Data cover 105 countries which constituted around 92% of total world imports in 2013 based on the IMF World Economic Outlook data. The category "other" consists of mixed end-use and miscellaneous goods

Still, despite the diminishing of these structural trade supports, we do expect some additional cyclical pickup in global trade growth in 2016 in proportion with global nominal demand – the latter led in our house forecasts by reflation in the DM world rather than in Asia itself: According Nomura forecasts, US and European imports will respectively grow 3.7% and 3.3% in 2016, and accelerate onward in 2017 to 4.7% and 3.9%. (The WTO forecasts similarly that world merchandise trade volume growth will pick up pace to 4.0% in 2016 from 3.3% in 2015.)

The subdued pace of Asia's export recovery has posed challenges for the consensus sales and earnings of key regional export bellwethers: Consensus FY16 and FY17 top-line sales growth for Taiwan's Tech sector, for example, have been downgraded to 'just' 3.5% and 4.7%, respectively, from May/August peaks of 5.8% and 5.7%. Similarly, Korean Tech FY16 and FY17 sales growth have been respectively downgraded to 2.1% and 3.3%, from 4.7% (for both) at mid-year. From current more conservative levels, however — and with a positive outlook for DM demand recovery in 2016-17 — we expect the downgrade trend to stabilize from here, and many export-driven sectors and stocks to outperform.

Fig. 119: FY15-17 consensus sales growth for Taiwan IT

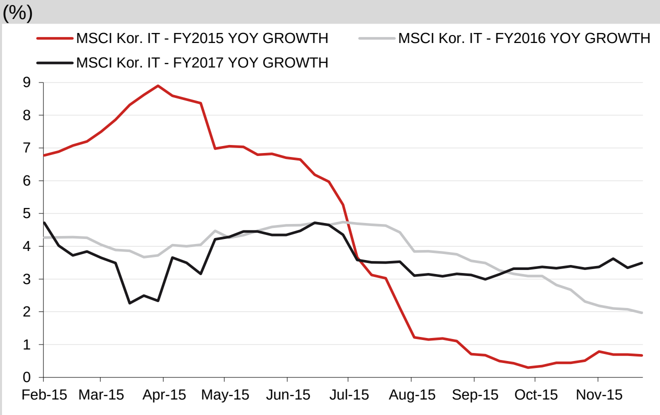
(%)



Source: Datastream, Nomura Strategy

Fig. 120: FY15-17 consensus sales growth for Korean IT

(%)



Source: Datastream, Nomura Strategy

But despite a still-strengthening *nominal* demand (and thus, corporate revenue) environment, the rising risks of a regional 'credit crunch' described in this report also suggest a prudent dialling down of *leverage* in the context of our still cyclical/growth-focused country, sector and style preferences — as well as some increased emphasis on *quality* in the effort to bolster portfolio resilience to such potential shocks.

Putting it all together, **Figure 121 summarizes our recommended Asia-Pacific ex-Japan Country and Sector allocations:**

Fig. 121: Nomura recommended Asia-Pacific ex-Japan Country and Sector allocation

Country Allocation

	MSCI	Nomura Recommendation				
	Abs Weight (%)	Abs. Weight (%)	Rel. Weight (ppt)		*Prev. Rel. Weight (ppt)*	
Australia	21.5%	16.5%	-5.0	Under	*-4.0*	*Under*
China	21.8%	21.8%	0.0	Neutral	*0.0*	*Neutral*
Korea	14.7%	17.7%	3.0	Over	*1.0*	*Over*
Taiwan	11.3%	14.3%	3.0	Over	*3.0*	*Over*
Hong Kong	10.0%	6.0%	-4.0	Under	*-3.0*	*Under*
India	7.6%	11.6%	4.0	Over	*4.0*	*Over*
Singapore	4.1%	4.1%	0.0	Neutral	*1.0*	*Over*
Malaysia	3.0%	2.0%	-1.0	Under	*-1.0*	*Under*
Indonesia	2.2%	2.2%	0.0	Neutral	*-0.4*	*Under*
Thailand	2.0%	1.0%	-1.0	Under	*-0.6*	*Under*
Philippines	1.3%	2.3%	1.0	Over	*0.0*	*Neutral*
Total	100%	100.0%	0.0		*0.0*	

Sector Allocation

	MSCI	Nomura Recommendation				
	Abs Weight (%)	Abs. Weight (%)	Rel. Weight (ppt)		*Previous Rel. Weight (ppt)*	
Financials	37.6%	40.1%	2.5	Over	*4.0*	*Over*
-Banks	20.6%	25.1%	4.5	Over	*5.0*	*Over*
-Insurance	6.6%	8.6%	2.0	Over	*2.0*	*Over*
-Real Estate	7.2%	3.2%	-4.0	Under	*-3.0*	*Under*
-Other	3.2%	3.2%	0.0	Neutral	*0.0*	*Neutral*
Information Technology	17.1%	21.1%	4.0	Over	*5.0*	*Over*
Materials	6.2%	4.2%	-2.0	Under	*-2.0*	*Under*
Industrials	8.6%	11.6%	3.0	Over	*3.5*	*Over*
Consumer Discretionary	6.9%	8.9%	2.0	Over	*2.0*	*Over*
Energy	4.3%	2.3%	-2.0	Under	*-1.5*	*Under*
Consumer Staples	6.1%	3.1%	-3.0	Under	*-6.0*	*Under*
Telecommunication Services	5.8%	3.3%	-2.5	Under	*-2.5*	*Under*
Utilities	3.9%	1.9%	-2.0	Under	*-1.0*	*Under*
Health Care	3.5%	3.5%	0.0	Neutral	*-1.5*	*Under*
Total	100%	100%	0.0		*0.0*	

Source: Datastream, Nomura Strategy

These same macro considerations also underpin our basket of 26 regional ‘Top Picks’ for 2016 (Figure 122). Historically, rising US interest rate periods have generally supported Growth stocks more than Value stocks — particularly relative to *Income*-delineated value styles (i.e. Dividend Yield). And indeed since mid-2014 Growth *has* been consistently the top-performing equity Style in Asia-Pacific ex-Japan, while Value and its subset Dividend Yield have been the weakest (Figure 153 on page 93). Moreover in terms of more recent actionable changes, we note that *Gearing* has begun substantially *underperforming* in APXJ since mid-2015, while the Quality factor has been rallying (again, page 93).

Thus our portfolio ‘Top Picks’ are chosen in no small part for their healthy balance sheets, proven profitability and sound corporate governance — qualities that we think would give them resilience in a macro environment of rising credit risks:

- In aggregate our list features an average Net Debt to Equity ratio (ex-Financials) of *negative* -9% (i.e. net cash); and no individual non-Financial stock exceeds a Net Debt/Equity ratio of 35% — whereas by comparison, *our 2015 ‘All Stars’ list* tolerated several stocks of significantly high leverage and bore an *average* ex-Financial Net Debt to Equity ratio of 46%). Our 26 Top Picks also boast an average Altman Z-score of 7.1 (note: an Altman score of higher than 3.0 indicates strong solvency).
- Our quality emphasis is reflected, for example, in a simple-average trailing ROE of no less than 18.3% (i.e. 7.0pp higher than the region-wide average of 11.3%).
- As a result, however, our 2016 ‘Top Picks’ basket features a substantially lower average beta than our 2015 ‘All Stars’ basket, at 0.9x (vs. 1.1x last year). In essence, we are trading away some potential upside sensitivity in order to gain resilience vs. potential adversity.

Fig. 122: Nomura Asia-Pacific ex-Japan 26-Stock 'Top Picks' for 2016

Country	Ticker	Company Name	Rating	Upside to TP	Analyst	Sector	Market Cap US$mn	3-mo ADV US$mn	Beta vs. Local	ROE Trailing, %	Dividend Payout Ratio Trailing, %	Altman Z-score	Net Debt to Equity Trailing, %	PER FY15	Disc./ Prem.	PBV Trailing	Disc./ Prem.	Nomura EPS Growth FY15	Nomura EPS Growth FY16	Nomura EPS Growth FY17
China/HK	1833 HK	**Intime Retail**	Buy	**86%**	Chan, Katherine	Discretionary	2,109	9	0.7	**11.5**	**43**	**1.3**	**34.3**	14.5	-14%	1.2	-47%	6%	9%	8%
	2388 HK	**BOC Hong Kong**	Buy	**38%**	Jiang, Sophie	Financials	33,008	42	0.9	**14.6**	**48**	**NA**	**NA**	9.8	-43%	1.4	-29%	9%	8%	9%
	2601 HK	**China Pacific**	Buy	**48%**	Tang, Shengbo	Financials	37,792	46	1.3	**10.2**	**41**	**NA**	**NA**	14.9	-43%	1.9	-19%	59%	11%	14%
	152 HK	**Shenzhen Int'l**	Buy	**33%**	Lam, Shirley	Industrials	3,126	5	0.7	**14.1**	**39**	**2.1**	**27.3**	11.7	-3%	1.3	-5%	15%	-1%	3%
	1766 HK	**CRRC**	Buy	**16%**	Xu, Patrick	Industrials	52,796	41	1.7	**13.7**	**-**	**2.6**	**6.1**	18.9	-17%	2.4	-17%	12%	26%	19%
	2018 HK	**AAC Technologies**	Buy	**12%**	Lee, Anne	Tech	8,864	26	0.3	**27.2**	**40**	**8.7**	**(1.9)**	18.4	6%	5.9	44%	32%	19%	9%
	700 HK	**Tencent Holdings**	Buy	**10%**	Orchard, Andrew	Tech	188,479	319	0.6	**34.5**	**11**	**5.6**	**(21.2)**	39.0	2%	11.1	-7%	24%	33%	27%
India	MSIL IN	**Maruti Suzuki**	Buy	**10%**	Singh, Kapil	Discretionary	20,792	66	0.8	**16.6**	**20**	**9.4**	**(11.0)**	39.5	90%	5.7	69%	43%	43%	24%
	AXSB IN	**Axis Bank**	Buy	**33%**	Parasrampuria, Adarsh	Financials	16,796	77	1.5	**17.9**	**18**	**NA**	**NA**	14.7	-17%	2.5	-18%	15%	24%	22%
	CCRI IN	**Container Corp. of India**	Buy	**22%**	Kedia, Amar	Industrials	4,142	5	1.0	**14.7**	**25**	**15.9**	**(36.1)**	27.4	22%	3.7	-31%	-4%	18%	23%
	HCLT IN	**HCL Technologies**	Buy	**17%**	Mehta, Ashwin	Tech	18,725	29	0.3	**32.7**	**11**	**11.5**	**(42.6)**	17.0	3%	4.8	-62%	7%	13%	11%
South Korea	011210 KS	**Hyundai Wia**	Buy	**24%**	Hong, Angela	Discretionary	2,923	16	0.7	**17.0**	**5**	**NA**	**8.2**	8.0	-32%	1.0	-50%	-4%	11%	10%
	090430 KS	**Amorepacific**	Buy	**31%**	Song, Cara	Staples	21,149	56	1.6	**11.9**	**16**	**15.8**	**(16.7)**	44.7	41%	7.4	99%	42%	34%	26%
	005830 KS	**Dongbu Insurance**	Buy	**51%**	Na, Michael	Financials	3,937	17	0.4	**13.5**	**22**	**NA**	**NA**	10.0	11%	1.1	-12%	6%	16%	12%
	005930 KS	**Samsung Electronics**	Buy	**29%**	Chung, CW	Tech	167,117	272	1.1	**13.1**	**13**	**3.9**	**(30.1)**	9.6	9%	1.0	-26%	-8%	6%	2%
	051910 KS	**LG Chem**	Buy	**42%**	Park, Cindy	Materials	18,339	60	1.6	**6.6**	**34**	**4.7**	**9.5**	17.3	13%	1.6	-24%	45%	23%	22%
Taiwan	9904 TT	**Pou Chen**	Buy	**24%**	Huang, Caren	Discretionary	3,969	13	0.4	**13.1**	**51**	**2.2**	**12.6**	12.0	10%	1.9	18%	34%	27%	15%
	2382 TT	**Quanta Computer**	Buy	**41%**		Tech	6,183	11	0.5	**14.8**	**82**	**2.5**	**(11.1)**	11.3	-6%	1.6	-27%	-5%	28%	20%
	2330 TT	**TSMC**	Buy	**14%**	Jeng, Aaron	Tech	112,292	144	0.7	**27.9**	**44**	**7.1**	**(17.8)**	12.2	-16%	3.2	-4%	16%	2%	11%
	3008 TT	**Largan Precision**	Buy	**38%**	Lee, Anne	Tech	10,694	100	0.7	**50.7**	**35**	**13.4**	**(59.2)**	14.3	-26%	6.1	12%	26%	5%	12%
Indonesia	BMRI IJ	**Bank Mandiri**	Buy	**23%**	Singh, Jaj	Financials	15,001	14	1.7	**20.9**	**25**	**NA**	**NA**	10.7	-37%	1.9	-23%	7%	14%	18%
	PTPP IJ	**PT PP**	Buy	**32%**	Yunus, Anthony	Industrials	1,286	2	1.1	**24.3**	**20**	**2.5**	**(8.3)**	25.8	34%	6.7	73%	33%	32%	38%
Malaysia	MAY MK	**Malayan Banking**	Buy	**17%**	Singh, Jaj	Financials	19,367	24	NA	**13.6**	**78**	**NA**	**NA**	12.2	-29%	1.3	-39%	-1%	7%	10%
Singapore	DBS SP	**DBS Group**	Buy	**37%**	Singh, Jaj	Financials	29,541	67	1.1	**11.2**	**36**	**NA**	**NA**	9.6	-37%	1.1	-19%	11%	18%	17%
	RFMD SP	**Raffles Medical**	Buy	**25%**	Divekar, Raghavendra	Health Care	1,692	2	0.5	**13.4**	**46**	**14.0**	**(26.6)**	33.7	61%	4.1	21%	5%	10%	15%
Thailand	ROBINS TB	**Robinson Dept. Store**	Buy	**25%**	Spiewak, Marcin	Discretionary	1,356	2	1.0	**16.3**	**52**	**3.6**	**5.6**	23.0	32%	3.8	11%	13%	17%	21%
		2016 Top Picks average		**30%**					**0.91**	**18.3**	**33**	**7.1**	**(9.4)**	**18.5**	**3%**	**3.3**	**-6%**	**17%**	**17%**	**16%**

Note: Maruti Suzuki, Axis Bank and CCRI have March year-endings; for comparability, 2015 for these companies means April 2015 to March 2016, and so on.

HCL Tech has June year-endings; for comparability, 2015 for HCL Tech means July 2015 to June 2016.

The average for Net Debt to Equity and Altman Z-score exclude Financials

Prices as of 30 November, 2015. Source: Bloomberg, Nomura Research

- The latter represents another significant change from our 2015 'Top Picks' basket, in which *superior earnings growth* was the predominant qualification. Still, even our 2016 basket's average FY16F and FY17F EPS growth of 17.4% and 16.1%, respectively (per our analysts' forecasts) considerably exceed consensus market-wide earnings growth expectations of 5.7% and 10.5%.
- Our 26 'Top Picks' also enjoy a simple-average 30.0% upside to Nomura analysts' target prices – also significantly higher than Bloomberg consensus upside of 19.6% for the same basket of names; and our individual target prices are higher than consensus in all but three of these 26 names.

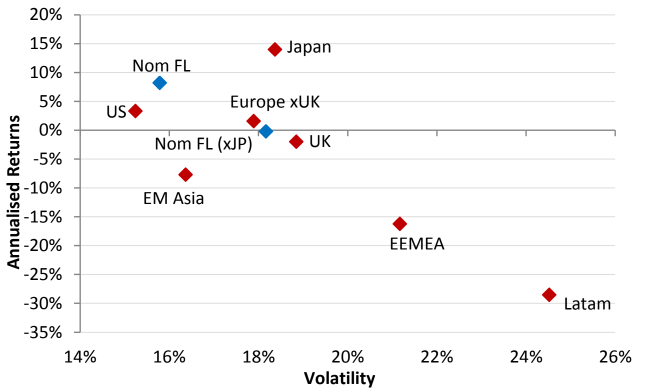
For a more in-depth elaboration of Nomura Asia-Pacific ex-Japan equity sector views and our 26 individual regional 'Top Picks' for 2016, please see our Equity Strategy companion report: *Asia-Pac ex-Japan 2016 Outlook – The stock picks*, published separately.

Forgettable 2015 brought resurgent risks. EM Asia has substantially outperformed its Emerging Market peers (Latam and EEMEA) in 2015, with both considerably less negative return (annualized -9% vs. -30% and -16% respectively – Figure 123) and substantially lower volatility (i.e. 16% vs. 24% and 21%). But the region's Sharpe ratio YTD ultimately falls short of *all* major Developed Markets at -0.58 (Figure 124).

- By comparison, Japan's 14% annualized YTD return is the strongest of any major equity market in 2015 (even in USD terms net of the yen's -2.8% YTD depreciation); and although this came at a cost of greater volatility (18%) than the US (15%) or Asia ex-Japan, it leaves Japan with the highest Sharpe ratio of any major global equity market, at 0.80.
- Of note, however, our *Asia-Pacific (including Japan) Equity Strategy 'Focus List'* has provided superior returns in 2015 relative to the benchmark (i.e. total return of +4.6% vs. -2.3% for the benchmark; Figure 125), with lower volatility than even EM Asia, let alone Japan. And on an Asia *ex*-Japan basis our Focus List is beating the benchmark by +630bp (i.e. total return of -3.3% vs. -9.6% for the benchmark).
- Thus far in 2H15 our (still Growth-biased) Focus List has continued to beat the benchmark by roughly +390bps in the Asia-Pacific (incl. Japan) context (i.e., down -3.4% vs. -7.3% for the benchmark) and by nearly +300bps in the Asia ex-Japan context (i.e., down -8.0%, vs -11.0%).

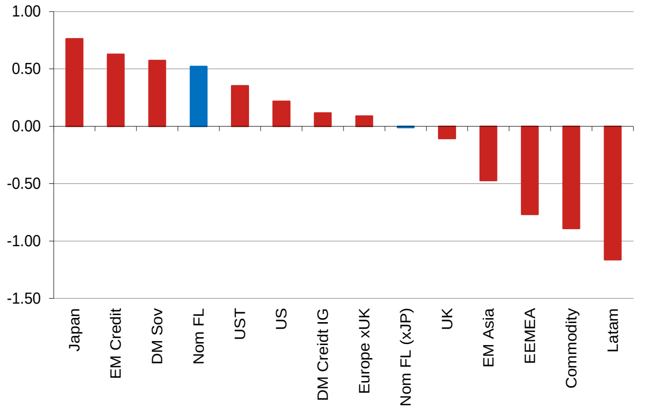
Fig. 123: Global Equity Markets and Nomura Asia-Pacific (incl. and ex-Japan) 'Focus List': 2015 YTD Annualized Return & Volatility

Returns in USD terms



Source: Bloomberg, Nomura Strategy

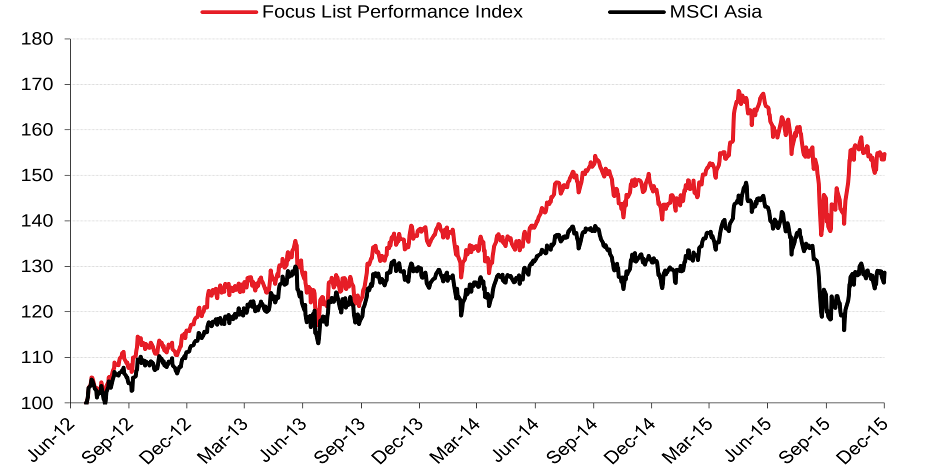
Fig. 124: Global Asset Markets and Nomura Asia-Pacific (incl. and ex-Japan) 'Focus List': 2015 YTD Sharpe Ratio



Source: Bloomberg, Nomura Strategy

Fig. 125: Nomura Asia-Pacific 'Focus List' performance vs. MSCI benchmark

Total return (USD terms)



Source: Bloomberg, Nomura Strategy

Fed 'liftoff' and Asian stocks: Start of hikes is seldom the end of gains

Stocks and other financial assets tend to move *en masse* in times of panic, pushing correlations toward 100% as all risk is avoided more or less indiscriminately. Thus the surge in Asian equity market and sector correlations in 2H15 along with the increased Equity Risk Premium (Figures 107 and 108 above) — suggest capacity for risk-bearing has declined and that investors are more on the back foot regarding various macro risks as we enter the New Year (e.g. Fed tightening, China slowdown, and heightened global geopolitical tensions).

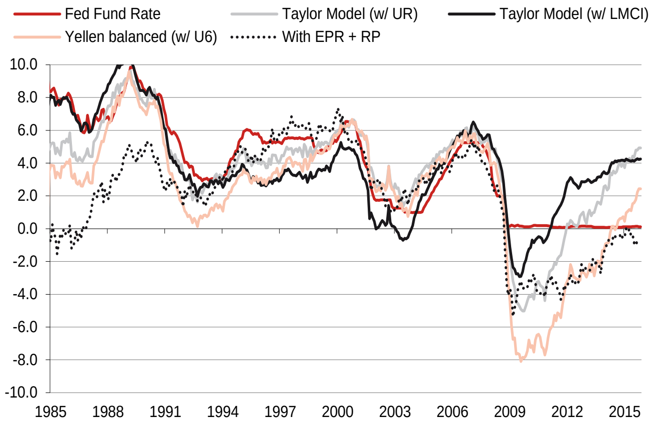
Yet historically, at least, the early phase of a Fed hiking cycle — which our economists expect to commence with the December 15-16 (2015) FOMC meeting — seldom spells the end of the upside for risk assets. This is because in most cases, rate hikes come as a response to *accelerating nominal growth* — growth that ultimately underpins both general risk tolerance and, specifically, corporate earnings. (It is on this point that more bearish equity narratives based on a 'rising discount rate' often stumble: only in textbooks can discount rates be raised in *ceteris paribus* isolation; in the real world, the discount rate *and expected future growth* often move together, especially early in the interest-rate cycle.)

If anything, there *may* be even less reason for stocks to fear initial tightening in the imminent Fed cycle, given both 1) how extraordinarily loose (and therefore growth-supportive) US monetary settings are in *absolute* terms — and will still be even after 'liftoff' — as well as 2) the likelihood of an extraordinarily shallow tightening *trajectory*:

- Various versions of the Fed's own 'Taylor Rule' model suggests the 'neutral' Fed Funds target rate currently should already be between 2.0% and 5.0% (as opposed to the current zero – Figure 126).
- And in terms of both the magnitude and pace of Fed tightening, our economists do not expect anything like the 1994-95 (i.e., 300bp in just 12 months, peaking at 6.0%) or 2004-06 (425bp total, peaking at 5.25%) tightening agendas. Rather, they look for a much shallower pace of ~75bp/year and much lower terminal Fed Funds rate (at ~200bp – Figure 127).

Fig. 126: 'Taylor Rule' (various versions) vs effective Fed Funds rate

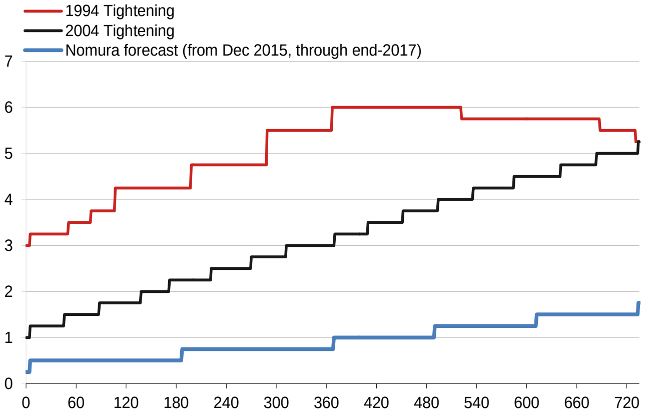
(%)



Source: Bloomberg, Nomura Strategy

Fig. 127: Fed 1994-95 and 2004-06 rate cycles vs. Nomura (Dec.) 2015-17 forecast

(% and days from initial hike)

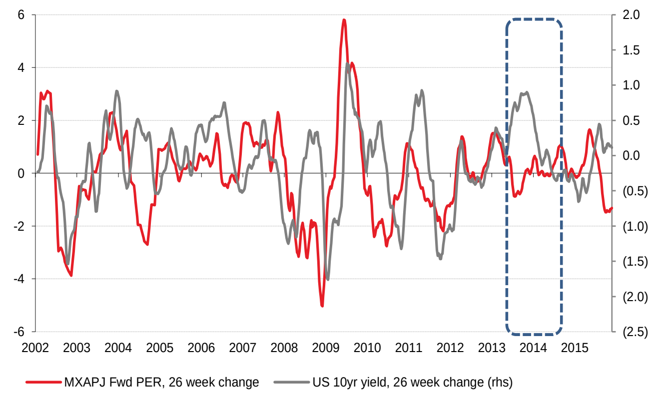


Source: Bloomberg, Nomura Global Economics, Nomura Strategy

Moreover, farther out the yield curve, data in fact point to *positive* relationships most of the time between rising US rates and 1) *higher* Asia-Pacific ex-Japan equity PER multiples (Figure 128) as well as, in recent years, 2) stronger cross-border equity inflows *into* Asia ex-Japan (Figure 129). [The exception in both cases was the summer 2013 'taper tantrum' (circled in both charts) during which these correlations reversed.]

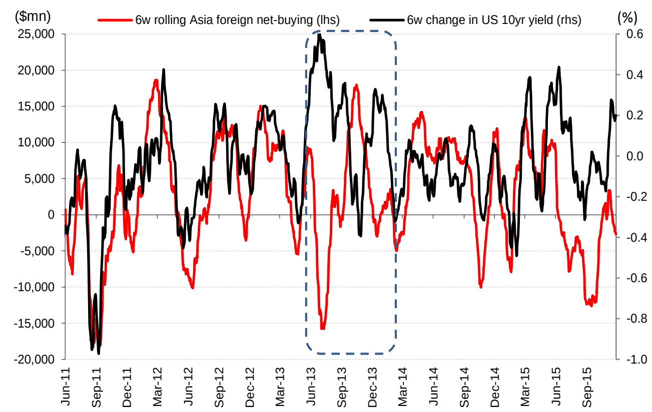
- In part this is simply because rising long-end yields often mechanically reflect *bond selling* — activity that liberates liquidity from that asset class that must then redeploy into new assets. In an environment of rising growth and/or inflation expectations, more often than not *equities* are the main asset-class beneficiary of such rotational bond outflows.
- While we would not want to infer *too* scientific a relationship, Figure 128 suggests that in approximate terms, a 30bp back-up in rates in 2016 (as per Nomura house forecasts) correlates visually with a roughly 0.8 multiple-point increase in Asian-regional PER multiples — arguably rendering our 12.4x end-2016 PER target conservative.

Fig. 128: Change in UST yields vs change in MSCI AC APXJ forward PER



Source: Bloomberg, Datastream, Nomura Strategy

Fig. 129: Change in UST yields vs foreign buying of Asia ex-Japan equities

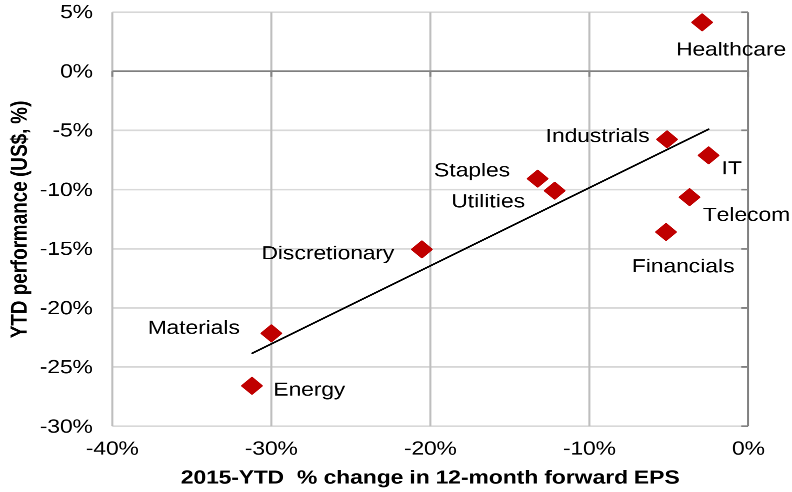


Source: Bloomberg, Nomura Strategy

It has been our assertion for some time that global stocks *are* indeed being driven primarily by growth and earnings expectations (see, for example, *Take my punchbowl* *please*, 19 September 2014), and not merely by "liquidity" or the outlook for central bank actions in and of themselves.

- Note in Figure 130 the strongly positive-sloping relationship between Asia-Pacific ex-Japan equity sector performance this year and the revision of rolling 12-month forward earnings consensus estimates. In other words, actual Asia-Pacific stock performance appears to be highly sensitive to *growth expectations* — despite commonplace media narratives emphasizing "liquidity-driven markets".

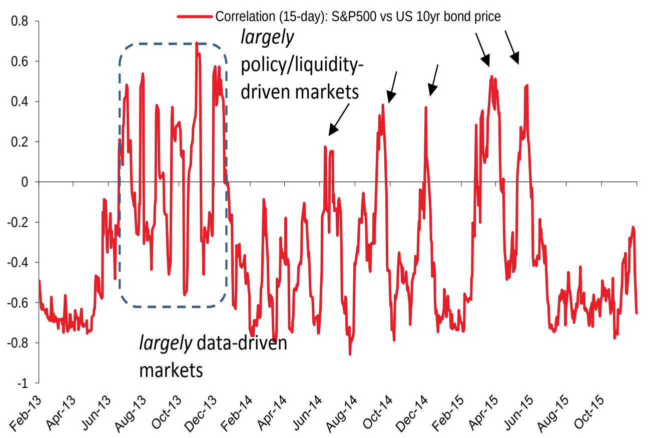
Fig. 130: MSCI APxJ sector performance vs. rolling 12m fwd earnings consensus revision (Jan. 2014 to-date)



Source: Datastream, Nomura Strategy

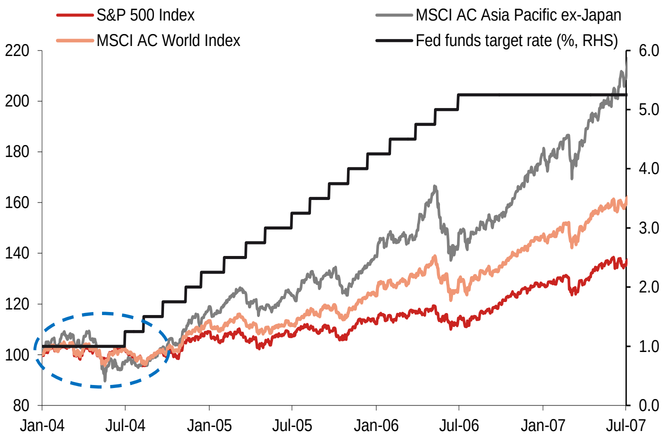
- Indeed looking at shorter-term (15-day) correlations over the past few years (Figure 131), we see that bond *yields* (as opposed to bond *prices*) have been more consistently positively correlated with equities – i.e. (again) it is primarily *growth expectations* as opposed to "liquidity expectations" driving the relationship (the 'taper tantrum' months of 2013 and September 2014, circled, were again key exceptions, when the correlation was instead volatile and inconsistent).
- Otherwise, inversions of this relationship (indicated), while not rare, tend to be *brief* as equities initially pull back on the pure uncertainty fuelled by momentary bond market disorder. But when the dust settles and the reality of strengthening reflationary demand remains intact, the correlation tends to revert to its 'normal' negative value and equities are able to rebound via a discounting of future nominal growth expectations.

Fig. 131: Short-term correlation between US 10-yr Treasury bond (price) and S&P 500



Source: Bloomberg, Nomura Strategy

Fig. 132: Global equity market performance around the 2004-06 Fed hiking cycle



Source: Bloomberg, Nomura Strategy

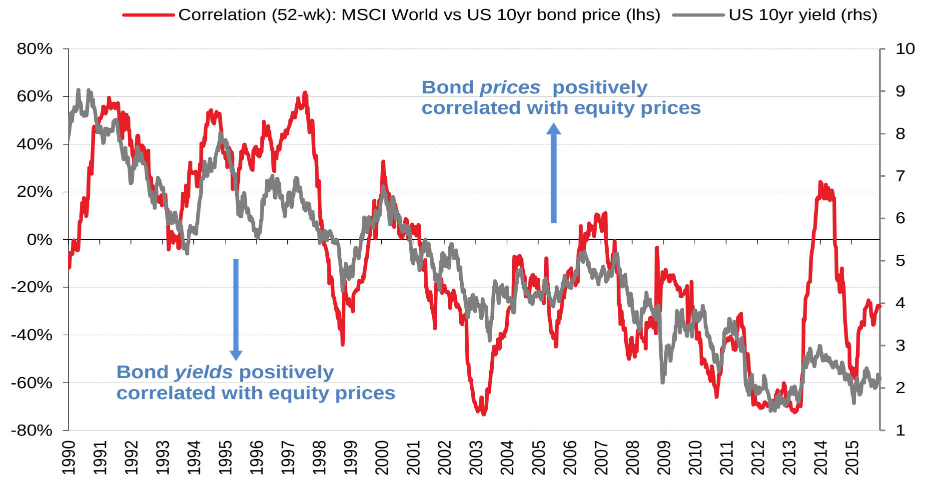
- Such correlation spikes are especially common in the months prior to the anticipated *starts* of Fed tightening cycles. The most recent Fed rate-cycle initiation (June 2004), for example, was preceded by *two* MSCI World pullbacks (and like-magnitude rebounds) of 5-6% in the 3-4 months before the first hike, and a 7% pullback shortly after (Figure 132, above); and Asia-Pacific ex-Japan stocks for their part corrected nearly *18%* over April-May 2004.

- Yet in the following three years through October 2007, the MSCI Asia-Pacific ex-Japan index and MSCI World went on to rally by 196% and 65%, respectively, even as the Fed progressively raised interest rates 425bp through mid-2006 – both handily outperforming the S&P500's still-respectable 45% gains over the same period.

As we noted in *Strangelove markets* (7 May 2015), the *absolute* level of rates matters for equities as well: By our reckoning, current bond yields are still far from absolute levels at which upticks should sustainably depress equities. Figure 133 shows historical absolute 10yr Treasury yields set against the correlation between bond prices and equity prices. As can be seen, it has historically only been when Treasury yields exceed roughly 5.0%-5.5% that higher yields (i.e., lower bond prices) seem to have a sustained *negative* impact on equities.

- There is a case to be made that this 'threshold' yield level should equate to roughly the potential growth rate of nominal GDP — and thus that it should be lower today than the 5.0-5.5% historical range (i.e., perhaps now 4.00-4.25%). Yet at roughly 2.2% currently, Treasury yields are nonetheless still well below even *that* presumptive lower range; thus higher rates from current levels — again, to the extent they reflect strengthening growth and/or reflation prospects — should be consistent with medium-term Asia-Pacific ex-Japan equity upside.

Fig. 133: MSCI World-US Treasury long-term price correlation & absolute US 10-yr yield

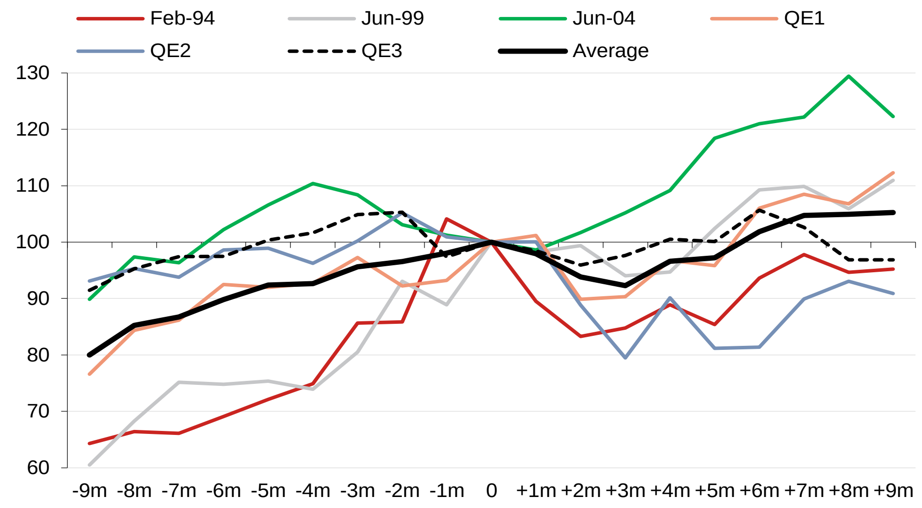


Source: Bloomberg, Nomura Strategy

Admittedly, Asian stocks' historical experience during previous tightening cycles (both rate hikes and the ends of QE episodes) suggests a trickier reality: In a *disorderly* unwind scenario (not our core view), in which a rapid back-up in yields hurts US growth and prompts renewed risk aversion globally, Asian equity markets — being both cyclically sensitive and in many cases comparatively higher-risk — would not be spared.

- As seen below in Figure 134, both the 1994 and 1999 US tightenings did halt and reversed for some two to three months the strong pre-tightening performance of Asian equity markets before gains resumed. (Indeed, the cycle initiated by the Fed in 1994 can in no small measure be charged as a contributing cause of the 1997-98 Asian Crisis, in our view.)
- Further, while the end of QE1 in March 2010 proved to be no lasting obstacle to an ongoing Asian equity rally (nor did the Fed's 2004 tightening, as noted previously), regional stocks also posted negative absolute returns subsequent to the June 2011 end of QE2, and performance has been lacklustre overall since the Oct 2014 ending of QE3 — although *we attribute this more to China growth concerns* than to Fed risks.

Fig. 134: MSCI APXJ performance around start of past US tightenings and QE-ends



Source: Bloomberg and Nomura Strategy

A coming reversion toward more normal (i.e. higher) US short-term interest rates and bond yields, though, *could* undermine both 1) the higher valuations of *particular* structurally weaker, higher-yielding Asia ex-Japan markets that have been propped by the easy availability of cheap cross-border 'carry' funding; and 2) still-crowded positions in Income- and Dividend-focused equity styles. The *relative* beneficiaries in the former case should be the structurally stronger Asia-Pacific markets able to stand on their own by virtue of more robust external accounts and/or strong domestic sources of capital formation; and in the latter case Asia's lower-yielding cyclical/growth markets and sectors (there is considerable overlap between these two groups in any event). We discuss these and other differentiating factors in the pages that follow.

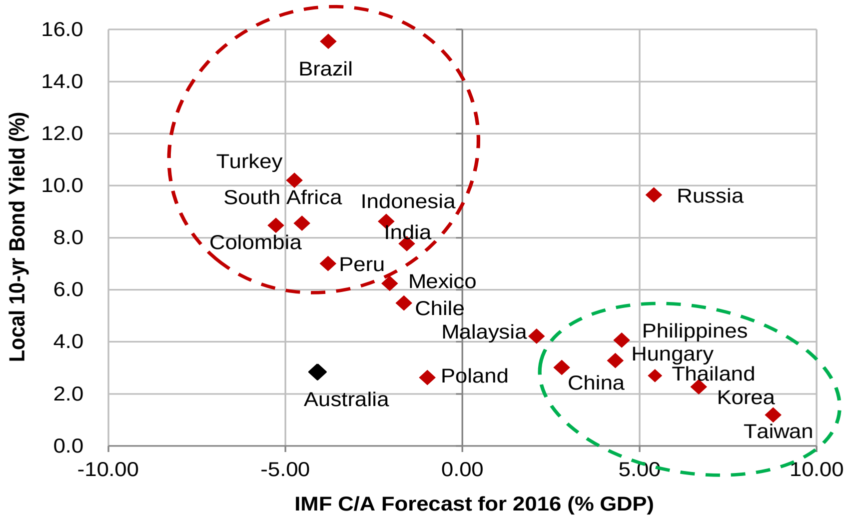
Equity differentiation (1): capital-surplus vs. -deficient markets

As we noted in our 2015 outlook (see *Choppy seas ahead*, 24 November 2014) equity markets in countries with higher reliance on external funding or direct linkages to Fed monetary policy would be more prone to rising risk premia induced by dearer offshore capital availability/cost (and the FX, monetary policy, growth and refunding risks that would follow). In this at-risk category we would principally identify Australia, Hong Kong and Indonesia, with India as a wild card (albeit one where we believe sufficient structural progress has been made in the last two years to render it considerably more resilient than it was, for example, during the summer 2013 'taper tantrum').

Broadly, we believe that equity performance during the 2013 'tantrum' still offers important *qualitative* clues for anticipatable Asian equity *relative* performance around a Fed lift-off. During that episode (and subsequent smaller/shorter risk spikes), capital outflows from structurally weaker Asian (and GEM) markets – primarily those with larger current account deficits and/or higher domestic yields that had attracted larger 'hot money' inflows (i.e., the upper-left-hand quadrant in Figure 135) – induced disproportionate volatility in equities and currencies, in turn often then forcing more reactive policy counter-measures that further impacted growth and corporate earnings prospects.

- By contrast we note that export-intensive North Asia (Taiwan, Korea and China) is well represented within the structurally *stronger* EM group (by this two-factor analysis, at least) in the lower right quadrant.
- Equally noteworthy is the degree to which that strongest GEM quadrant is dominated by *Asian* markets in particular (including also the Philippines and Thailand), with only *one* non-Asian EM — i.e. Hungary — sharing that distinction. This suggests Asian equities overall are much better configured to ride out the coming Fed cycle than their EM cousins in Latin America or EEMEA.

Fig. 135: GEM (and Australia) vulnerability to rising US rates: Current account balance and local benchmark yields



Source: Bloomberg, IMF, Nomura Strategy

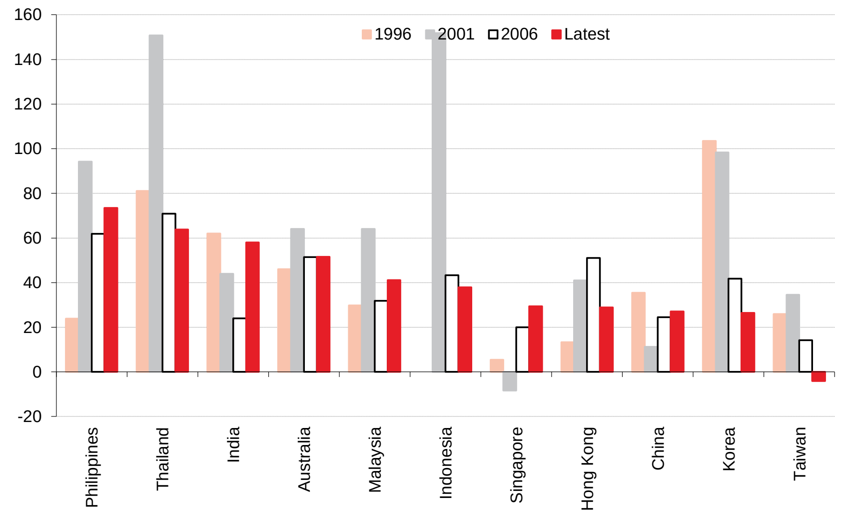
Importantly, though, while we believe that *qualitatively*, 'taper tantrum'-type EM equity differentiation by way of FX impact and carry-trade flows could return in 2016, *quantitatively* such effects might be less abrupt/disorderly than in the summer of 2013.

- Recall that Treasury yields in 2013 backed up by 140bp over just four months (2 May-5 September), for a riotous pace of ~35bp/month. By contrast, our Rates strategists' Treasury yield forecast through end-2016 (i.e. 2.5%) implies much more limited upside in the quarters ahead.
- Perceptions of Asian FX risk may also remain skewed by the massive currency maxi-devaluation experiences of the 1997-98 Crisis, in which devaluations of 50-80% were the norm. But such existential FX dislocations — and the proportional foreign debt service blowouts they imposed — were exacerbated by the existence of a *network of U.S. dollar-pegged currencies* at the time that essentially no longer exist (ex- the HK dollar).
- Those 1990s-era Asian dollar pegs created discrete 'hard targets' against which massive short positions could be built over months as central banks burned away forex reserves to maintain them; leading to outsized subsequent exchange-rate dislocations once those reserves ran out. Today, without the 1997 starting point of a web of dollar-linked currencies, strong-dollar pressures are relieved more gradually, in real time, with (generally) less drama or disorder.

Looking beyond macro risks and flows to *corporate* and Financial sector fundamentals (and bearing in mind that Financial sector stocks make up no less than 30% of Asia ex-Japan's market capitalisation — the region's single-largest GICS-1 sector), equities in countries that have exhibited greater financial leverage build-ups would likely be more hurt by tightening domestic liquidity conditions (including corporate-level solvency impacts) as external capital costs rise.

- In line with the discussion in the Economics section of this report (Figure 5 on p.12), this would include Hong Kong, Taiwan, Malaysia, Singapore and Thailand, in addition to China.
- But by contrast, looking specifically at leverage (by way of Debt/Equity ratios) more specifically in ex-Financial sector *listed Asia-Pacific ex-Japan equities* (Figure 136), we see reassuringly that *no* regional markets today exhibit the 80%-and-higher gearing levels that characterized Asia's weakest links in 1997 (such as Indonesia, Thailand and Korea). This suggests that much of the debt build-up noted in the Economics section of this report is happening *outside* the listed company space, leaving local banks potentially as concentrated pockets of equity market risk.
- That said, non-Financial sector corporate gearing in parts of EM ASEAN, India and Australia *is* high enough (at roughly 50% or more) to warrant close monitoring.

Fig. 136: Asia ex-Japan: ex-Financial sector Debt/Equity ratio, various periods



Source: Nomura StrategyInsights

FX factor. Apart from the impact of higher US rates on local currency index levels, we consider the impact of our FX team's expected currency moves on Asia-Pacific equity prospects in Figures 137 and 138. It summarizes the correlations of regional stock market performance (in both absolute terms and relative to the MSCI Asia-Pacific ex-Japan regional benchmark) vs. local currencies.

- Most Asian equity markets, of course, are *positively* correlated with their local currencies in terms of both absolute performance and relative to their relevant Asia-Pacific benchmark; but this does not mean that currency depreciations are uniformly negative for Asia-Pacific stocks.
- Rather, positive correlations can reflect the fact that historically it is often equity upside that helps drive FX upside (by way of cross-border portfolio capital flows); or it can be third factors — such as stronger exports in a recovering global growth environment — that buoys *both* equities and local FX.

That said, the highest correlations between Asia-Pacific currencies and their respective equity markets (absolute performance) are found in Malaysia, Indonesia, Korea and Taiwan. By contrast, Japan and China's domestic A-shares feature meaningfully negative correlations, meaning those equities may perform better as local currencies weaken as per our house view — in part, we think, because currency depreciation offers incremental relief from *deflationary* risks, which remain present in both economies.

Fig. 137: Asia-Pacific equity correlations with local FX rate

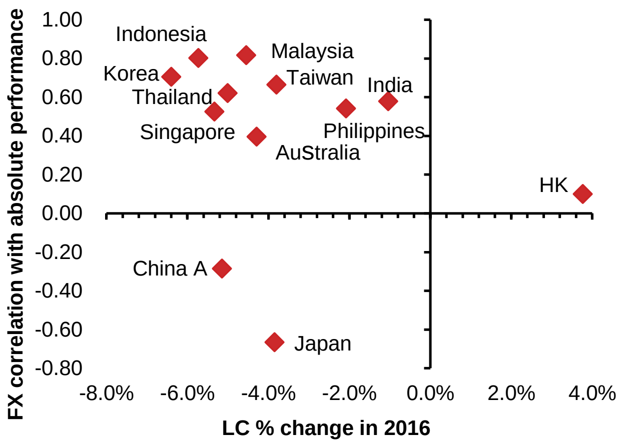
Absolute performance and relative to MSCI Asia-Pacific ex-Japan Index; HK correlations w/ DXY index

	Correlation of absolute performance		Correlation of relative performance	
Country	Current	1yr ago	Current	1yr ago
Malaysia	**0.82**	0.34	**0.70**	-0.02
Indonesia	**0.80**	0.50	**0.83**	0.60
Korea	**0.70**	0.20	**0.37**	0.20
Taiwan	**0.66**	0.04	**0.25**	-0.29
Thailand	**0.62**	0.46	**0.16**	0.38
India	**0.58**	0.49	**0.08**	0.46
Philippines	**0.54**	0.18	**-0.09**	-0.19
Singapore	**0.53**	-0.04	**0.37**	-0.07
Australia	**0.40**	0.28	**0.52**	0.46
Hong Kong	**0.10**	-0.24	**0.09**	-0.38
China A	**-0.29**	0.27	**-0.19**	0.25
Japan	**-0.67**	-0.72	**0.05**	-0.38

Source: Bloomberg, Nomura Strategy research

Fig. 138: Asia-Pacific equity-FX correlations & Nomura FX forecasts

Absolute performance; HK currency forecast is DXY



Source: Bloomberg, Nomura Strategy research; HK currency forecast is DXY

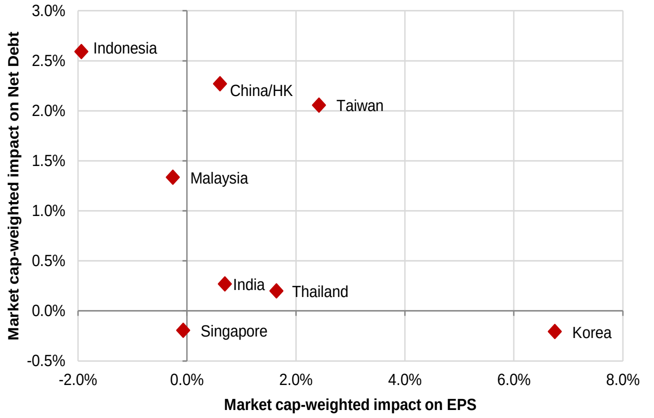
- We remain mindful of these correlations in light of our regional FX team's forecast for still material 2016 local-currency downside risks — particularly in Korea (-6.4% vs. the US dollar), Indonesia (-5.7%), Singapore (-5.3%) and Thailand (-5.0%). Figure 138 above plots our FX strategists' 2016 year-on-year (Dec/Dec) FX change forecasts vs.

the equity correlations detailed beside it in Figure 137: The comparatively more resilient (or even absolutely benefitted) markets would be India, the Philippines, China A-shares and also Japan.

- With *particular* respect to Nomura FX strategy's outlook for further roughly -5% Chinese yuan devaluation in 2016, bottom-up analysis of Nomura's >600-stock Asia-Pacific ex-Japan coverage area reveals that a RMB depreciation of roughly that magnitude (and 'sympathetic' follow-on declines in regional FX), other factors equal, would be net-*positive* from an earnings perspective for many regional equity markets, including China itself, Korea, Taiwan, Thailand and India — whereas negative earnings impacts by country are confined to ASEAN, most detrimentally in Indonesia (Figure 139).
- Similarly, by Asia ex-Japan sector we note that FX moves in our base case carry net-*positive* earnings implications for Tech, Capital Goods, Pharma, Energy and even Banks, among others (Figure 140 – although, as also shown, our FX assumptions also imply a substantial increase in *consolidated net debt* for Banks, Tech and Capital Goods, as well as for 'earnings-winner' countries China and Taiwan).
- Conversely, our base-case currency expectations are more earnings-negative in the Utilities, Materials, Media, Software & Services (due particularly to Chinese Internet names), and Consumer Durables sectors. [Note that the seemingly positive impact on Retail sector earnings in Figure 140 owes entirely to two US-listed Chinese Internet retailers; for the rest of the sector regionally, FX depreciation is a losing proposition for earnings.]

Fig. 139: EPS and Net Debt impact of 6% RMB depreciation

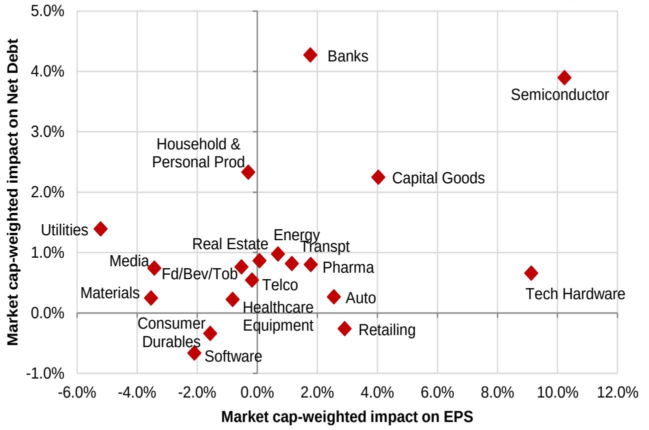
And follow-on Asian-regional FX declines; by country, local currency terms



Source: Nomura Equity Research

Fig. 140: EPS and Net Debt impacts of 6% RMB depreciation

And follow-on Asian-regional FX declines; by sector, local currency terms



Source: Nomura Equity Research

Moreover, as market movements in the aftermath of China's August 11 CNY liberalization largely confirmed (and our FX forecasts reflect), Chinese currency depreciation does not occur in isolation: In reality, the Asia-Pacific ex-Japan region depreciates to varying degrees *as a bloc*, allowing the entire region and its integrated supply / production chain to *gain competitiveness together*. Thus, many of the most positive earnings impacts noted above are in export-driven regional markets / sectors — including those that feed into the Chinese export final-assembly machine.

Box 15: Rising sums: Japanese capital embracing AXJ

Since the Global Financial Crisis in 2008 and Japan's catastrophic 2011 Tohoku earthquake/tsunami, Japanese companies have stepped up their overseas investment. 2015 is proving another big year, with more than US$82bn worth of cross-border deals already either completed or agreed at writing, up 60% y-y from 2014's US$51bn and more than double the US$40bn in 2013. Low domestic demand growth in Japan and associated low returns on investment, as well as a need to diversify production capacity and financial exposure, present a broad-based case for continued Japanese investment overseas beyond mere exchange-rate considerations. With US$340bn in cash on the balance sheets of the top 100 non-financial Japanese companies (44 of which are *net*-cash), there remains significant scope for further cross-border investments ahead.

Nomura Japan sector analysts have identified two distinct strategies for Japanese overseas investment: 1) the pursuit of immediate better returns in developed markets such as the US and Europe; and 2) pursuit of *longer*-term growth opportunities in emerging industries or economies. Looking at some of the largest recent Japanese investment deals, a third distinct strategy also appears to be emerging, i.e. 3) the acquisition of valuable established *brands*.

Fig. 141: Key Japanese overseas investments since 2014

Announce Date	Target	Country	Japanese investor	Announced Total Value ($mn)
1/13/2014	Beam Inc	US	Suntory Holdings	15581
1/20/2015	CITIC Ltd	China	ITOCHU Corp + CP Group	10356
6/10/2015	HCC Insurance	US	Tokio Marine Holdings	7480
2/17/2015	Toll Holdings	Australia	Japan Post	6271
6/4/2014	Protective Life Corp	US	Dai-ichi Life Insurance	5531
9/29/2015	Natural American Spirit	US	Japan Tobacco	5013
7/23/2015	StanCorp	US	Meiji Yasuda Life Insurance	4941
8/11/2015	Symetra	US	Sumitomo Life Insurance	3716
2/23/2015	Polypore International	US	Asahi Kasei	3225
12/2/2014	Avanir Pharmaceuticals	US	Otsuka Holdings	3170
2/10/2015	Axis Communications AB	Sweden	Canon	2357
9/22/2014	Cermaq ASA	Norway	Mitsubishi	1728
5/11/2015	ACORE Capital LLC	US	Tokio Marine	1600
3/10/2015	Domino Printing Sciences	UK	Brother Industries	1495
7/23/2015	FT Group	US	Nikkei	1309
8/19/2014	Waupaca Foundry	US	Hitachi Metals	1300
2/17/2015	APL Logistics Ltd	Singapore	Kintetsu World Express	1200
2/3/2014	Nippon Paint Chengdu	China	Nippon Paint	1021
6/3/2015	Coupang	South Korea	SoftBank Group	1000
9/30/2015	Social Finance Inc	US	Softbank + Others	1000
9/9/2014	Ebates Inc	US	Rakuten	981
2/14/2014	Viber Media Ltd	Cyprus	Rakuten	905

Note: includes concluded or pending deals of disclosed size only

Source: Bloomberg, Nomura Strategy

Fig. 142: Promising Countries/Regions for Overseas Japanese manufacturing business over the Medium term

Rank (FY15)	Country	No. of companies	% share of total
1	India	175	40.4
2	Indonesia	168	38.8
2	China	168	38.8
4	Thailand	133	30.7
5	Vietnam	119	27.5
6	Mexico	102	23.6
7	USA	72	16.6
8	Philippines	50	11.5
9	Brazil	48	11.1
10	Myanmar	34	7.9
11	Malaysia	27	6.2
12	Russia	24	5.5
13	Singapore	20	4.6
14	Turkey	17	3.9
14	Korea	17	3.9
16	Taiwan	16	3.7
17	Cambodia	14	3.2
17	Germany	14	3.2

Source: Survey Report on Overseas Business Operations by Japanese Manufacturing Companies - Results of the JBIC FY2015 Survey: Outlook for Japanese Foreign Direct Investment (26th Annual Survey).

Japanese direct investment into the rest of *Asia* has been particularly strong (Figure 143 below), with three notable points: 1) the bulk of the investment in the past three years has gone into ASEAN countries, which now account for fully *60%* of all Japanese FDI into Asia ex-Japan; 2) Japanese FDI into HK/China slowed noticeably in the 24 months following the H2 2012 maritime territorial disputes — although it has begun rebounding in 2015, if increasingly via HK rather than 'directly' into China; and 3) Japanese investment into *India* remains quite small, although India ranks #1 on the survey of "most promising" countries for future investment among Japanese corporates (Figure 142 above).

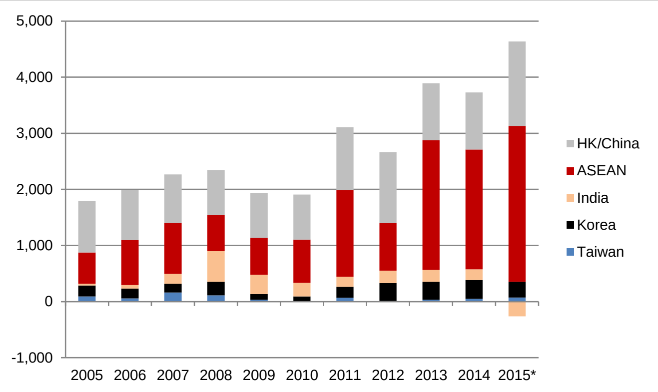
We continue to expect the bulk of Japanese FDI to be directed towards ASEAN markets, and see the Banking, Insurance, Retail, F&B and Logistics sectors as the likeliest deal destinations (see *ASEAN Strategy - Avenues for Japanese Investment*, 9 October 2015).

Investment into India should also pick up, commensurate with rapidly improving ties between the two nations (that happen to be the second- and third-largest economies in Asia on a PPP basis — see *Abenomics x Modinomics = Greater opportunities for Japan and India*, 16 July 2014).

Japanese cross-border *portfolio* equity investment, on the other hand, has historically been directed more towards developed markets (with the Kokusai benchmark having served as the primary guide). Thus, portfolio equity investment into Asia ex-Japan from 2008 to 2013 totalled only JPY 1.4tn, while over the same period Japan's *direct* investment in AXJ totalled JPY 16tn. This is changing in no small measure since trend-setting government pension giant GPIF's 'risk-friendly' October 2014 allocation strategy revisions (see *here*) — which increased overseas/equity allocations while also shifting to an EM-*inclusive* equity benchmark. With this has come a more than *5x* increase in Japanese equity portfolio investment into the rest of Asia (to more than JPY 2.1tn on an annual average basis in 2014-15 vs JPY 400bn annually over 2009-12).

Still the overall magnitudes remain less than game-changing for the recipient markets: In USD terms, the 12 months to September 2015 brought US$16.6bn in Japanese portfolio flows to the rest of Asia; this amounts to little more than roughly *one day's* aggregate regional trading volume and a small (albeit non-negligible) 0.6% of aggregate AXJ equity market cap. We note, however, that while India and Korea received the largest *absolute* increases in Japanese portfolio equity inflows in the 12 months to September 2015 (compared with calendar 2014) *Southeast Asia* seems to remain a favourite for Japanese portfolio investors as it is with FDI: Namely, ASEAN equities received a disproportionately larger share relative to their respective benchmark weights, despite the sub-region's comparatively challenging market environment in 2015.

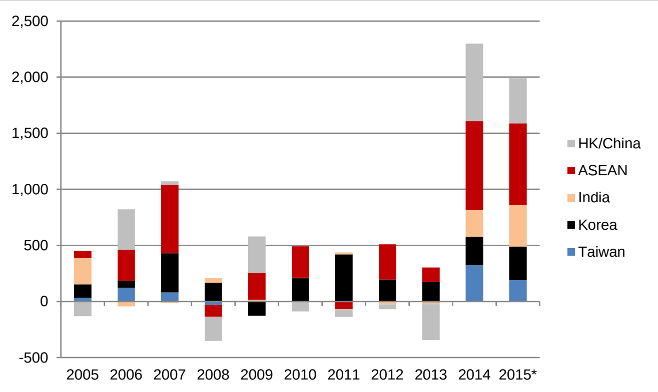
Fig. 143: Japan direct investment into Asia (JPYbn)



Note: *2015 values are rolling 12m sum to September 2015

Source: CEIC, Nomura Strategy

Fig. 144: Japan portfolio equity investment into Asia (JPYbn)



Note: *2015 values are rolling 12m sum to September 2015

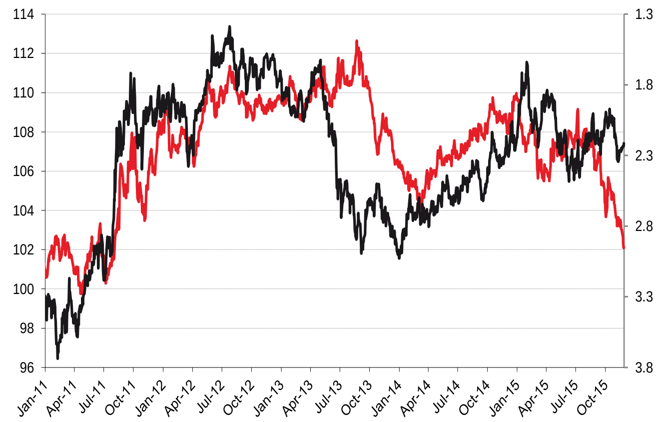
Source: CEIC, Nomura Strategy

Equity differentiation (2): Stick with Growth factor over Yield; reduce Gearing in favour of Quality

Historically, rising interest rate periods have generally been supportive of Growth more than Value stocks in the equity space — and particularly relative to *Income*-delineated value styles (i.e., Dividend Yield). Thus, the 2016 US interest-rate outlook should continue to support a portfolio bias for Growth (i.e. cyclical sectors) over Dividend Yield.

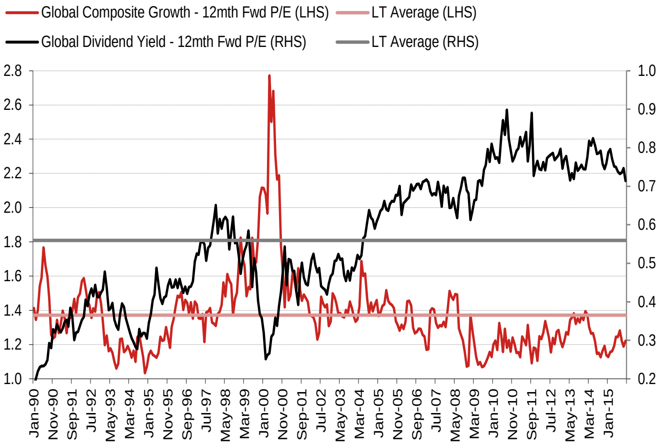
- Figure 145 refutes the often-repeated notion that "rotation out of bonds into equities first manifests itself as a baby-step into yield stocks." Rather, the evidence seems to suggest the *opposite* — i.e. that Asia ex-Japan Yield stocks do best when investors are moving *into* fixed income (i.e., seeking incremental safety rather than incremental risk).
- Specifically, we see that extended credit rallies in recent years (i.e., yield *declines* – note inverted scale), have coincided with outperformance in Asia ex-Japan Yield stocks — whereas for much of 2013, and again in H1 2015, rising US Treasury yields helped catalyze *underperformance* in Asia ex-Japan Dividend Yield plays.
- We also note that a preference for Growth over Income (and Dividend Yield specifically) is further supported by technical (i.e. valuation) considerations: Namely, Growth as a style currently offers a respectable ~11% valuation discount vs. long-term averages (Figure 146) — suggesting the style also remains under-owned by portfolio managers (and is likely to benefit from rotational buying in the months ahead as rates rise) — whereas the highly crowded nature of Dividend Yield plays is betrayed by that factor's elevated valuation *premium* of more than 27%.

Fig. 145: Asia ex-Japan High-Yield stock total return RPI and US 10-yr yield



Source: Bloomberg, Nomura Strategy

Fig. 146: Global Growth vs. Dividend Yield factor valuations



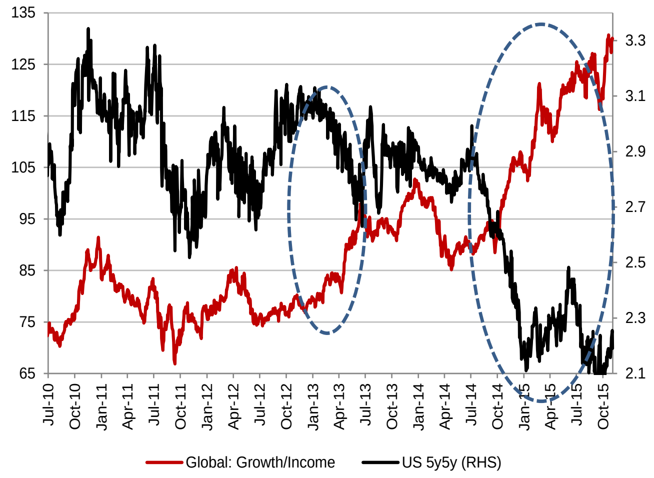
Source: Nomura Quantitative Strategy

Low oil: no friend to Dividend Yield. Moreover, we noted in *Cooking with oil* (15 January 2015) that historically, *inflation expectations* also *usually* exhibit a strong directional correlation with the relative performance of Growth vs. Income (i.e., Dividend Yield) in the global equity space (Figure 147). This would seem attributable largely to: 1) the positive relationship between inflation expectations and *demand* strength (which logically benefits cyclical stocks), as well as 2) between inflation expectations and *interest rate* expectations (which, when rising, undercut the relative performance 'bond proxy' Yield stocks).

- Yet despite lower inflation breakeven expectations along with declining oil prices since mid-2014, Growth stocks have continued outperforming Income (i.e. Dividend Yield) — a historically rare occurrence (again, Figure 147).
- This breakdown is, by our reckoning, one of the most convincing pieces of evidence supporting the demand-*positive* interpretation of oil's decline — essentially implying that low oil over the medium term will prove *inflationary* rather than deflationary, driven as it has been by increased supply as well as advancements in extraction technology rather than any demand decline (Figure 148) or new deflationary monetary error.
- As we have noted previously, beyond short-term 'mechanical' impacts of lower oil on CPI baskets (via such direct components as fuel prices and transport costs), lower energy prices, by supporting *stronger demand growth*, could ultimately speed the

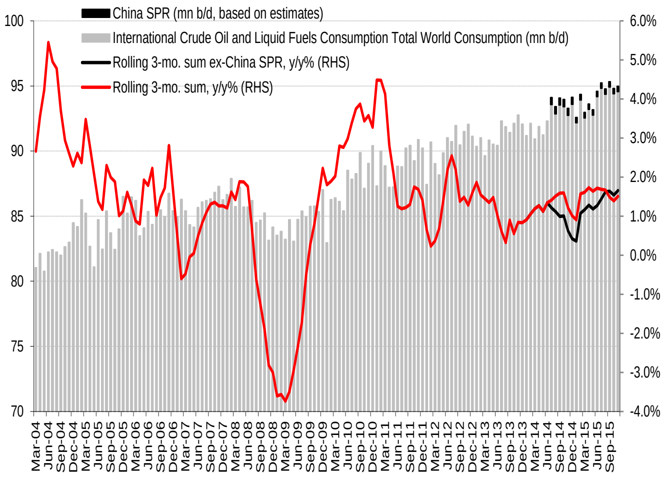
absorption of excess labour and industrial capacity — i.e., the closure of the 'output gap' — returning pricing power to all (i.e. inflation) that much sooner.

Fig. 147: Global Growth/Income relative performance vs. inflation BEI



Source: Bloomberg, Nomura Strategy

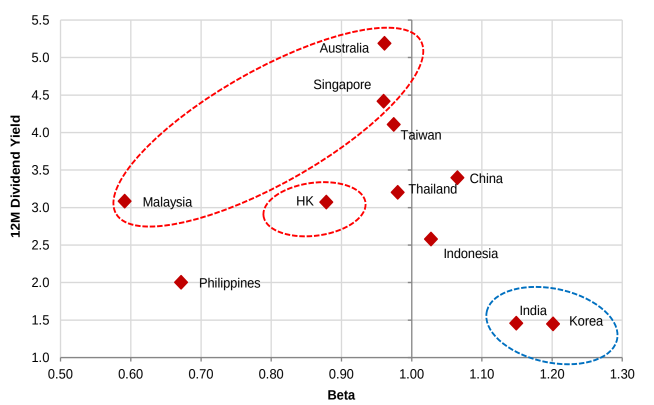
Fig. 148: Global total crude + liquid fuels consumption (Mbpd monthly avg.)



Source: Bloomberg, Nomura Strategy

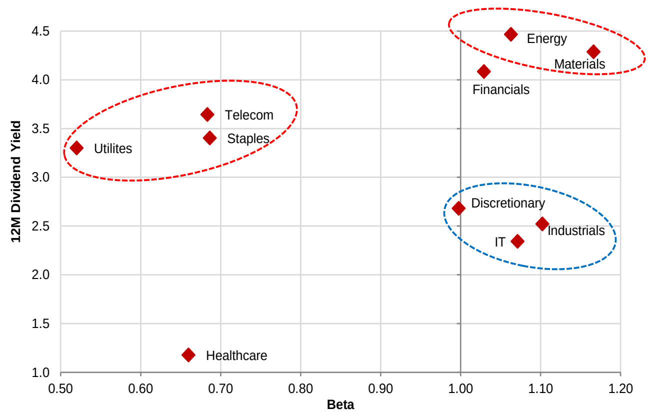
In the Asia-Pacific ex-Japan, the greatest country-level beneficiaries of such a style bias for Growth over Yield are Korea and India (both Overweight) at the expense of Australia, Hong Kong, and Malaysia (Underweight). And the region's greatest sector beneficiaries are Tech, Industrials and Discretionary (Overweight), while (upstream) Energy and Materials, Telecoms, Staples and Utilities should be Underweight (Figures 149 and 150):

Fig. 149: Asia-Pac ex-Japan: beta vs. dividend yield by market



Source: Bloomberg, Nomura Strategy

Fig. 150: Asia-Pac ex-Japan: beta vs. dividend yield by sector

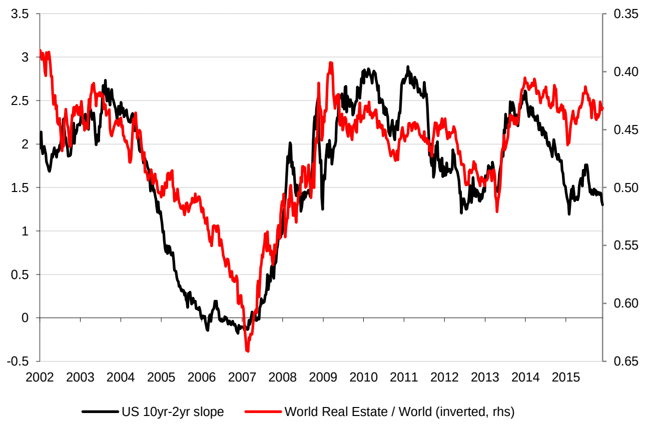


Source: Bloomberg, Nomura Strategy

Sector-wise, we also note that within the broader Financial sector globally, Property stocks underperform when the US Treasury curve steepens (Figure 151) — and that Hong Kong in particular has Asia's largest percentage of Property to total market cap (at >30%).

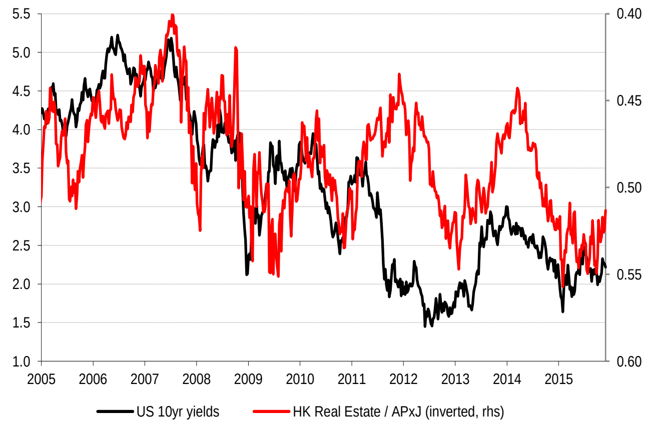
- While it is true that the Treasury curve may be less inclined to steepen once the short end begins to move more — indeed our house 2016 forecast suggests only modest upside to 10-year Treasury yields, to 2.5% — historically the relative performance of Hong Kong Property stocks is also inversely correlated to the *absolute level* of long-end Treasury yields (Figure 152).
- This suggests that only in a 2004-style 'bond conundrum' (in which long-end yields remain unmoved by Fed short-end rate hikes, or even decline and invert) would Hong Kong or regional Property stocks likely become attractive in the year ahead.

Fig. 151: US yield curve slope & relative performance of World AC Real Estate index



Source: Bloomberg, Nomura Strategy

Fig. 152: US 10yr yield & relative performance of HK Real Estate vs. Asia Pacific ex-Japan benchmark

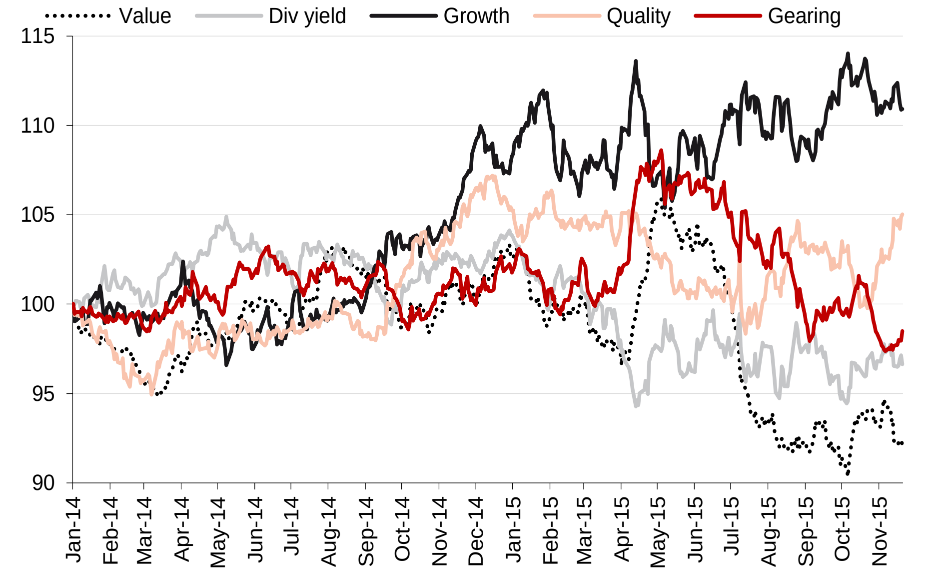


Source: Datastream, Bloomberg, Nomura Strategy

Reduce Leverage while increasing Quality emphasis. But while Growth has been the stand-out most consistent outperforming equity Style factor in the Asia-Pacific ex-Japan region since mid-2014, and Value & Dividend Yield the two weakest (Figure 153), 2015 *has* also brought noteworthy changes in particular style factors: Namely, Gearing has begun underperforming in Asia ex-Japan since mid-2015, while the Quality factor has begun to come on stronger:

Fig. 153: Asia ex-Japan equity performance by style factor

(Jan. 2014 = 100)



Source: Datastream, Nomura Strategy Research

With the above — and particularly in light of our Economics team's concerns regarding rising credit crunch risks in 2016 — we believe Asia ex-Japan equity investors should reduce exposure to Gearing while increasing emphasis on Quality in the year ahead — while *sticking with* a 'primary' factor preference for Growth over Yield.

Equity differentiation (3): Resource consumers vs. producers

Another key performance differentiator in months ahead, we think, will continue to be between *net exporters vs. net importers of energy & commodities* (circled column in the 10-factor EM risk matrix, Figure 154).

- We believe the combination of Fed tightening, (resulting) *continued US dollar strength* and our economists' view for a continued *medium-term moderation in China's growth* (along with booming US 'fracking' and shale gas production and Japan moving to gradually restart several of its nuclear power plants) all may conspire to *sustain* 1996-99 style commodity- and oil-price downside risks *despite* a (DM-led) overall pick-up in global GDP growth.

- If so, this would continue to effect a relative transfer of income and benefit to downstream (i.e. resource *consuming*) markets – principally Asia ex-Japan and Eastern Europe – from resource *producers/exporters* such as Latin America and South Africa (as well as Australia and Canada in the DM space).

Fig. 154: GEM vulnerability to the higher US Treasury yield, stronger US dollar, softer commodity/energy price scenario

Region	Country	Consensus 6-mo. GDP revision (%)	Primary industry as % of GDP	Net exports of energy / commodity as % of GDP	Curr/Acct as % of GDP (2015 forecast)	10 year local yield (%)	3-mo. FX Volatility	Private non-financial credit % GDP (latest)	Change in private non-financial credit % GDP since 2008	Private non-financial debt: external / total (%)	Total External Debt (% of GDP)	Total 'Vulnerability Score'
Asia-Pac ex-Japan	Philippines	-0.6	14.5	-3.7%	5.0	4.1	5.9	35.7	2.1	24.6	25%	1
	Taiwan	-2.2	1.9	-10.0%	12.4	1.2	6.8	140.1	12.1	6.5	36%	2
	India	0.1	21.8	-6.3%	-1.4	7.7	7.2	60.0	3.7	19.0	22%	2
	Korea	-0.5	2.4	-10.0%	7.1	2.3	10.7	190.4	15.4	4.7	30%	2
	China	-0.1	13.6	-3.9%	3.1	3.1	5.6	198.2	81.4	1.9	8%	2
	Thailand	-0.8	16.2	-13.1%	6.2	2.7	7.3	121.0	28.7	17.6	37%	3
	Indonesia	-0.4	20.0	0.3%	-2.2	8.5	13.3	39.3	11.9	40.2	35%	5
	Malaysia	0.0	19.0	2.1%	2.2	4.2	13.3	134.8	23.6	17.4	67%	6
EEMEA	Poland	0.0	4.7	-3.2%	-0.5	2.7	12.2	81.9	11.7	34.4	71%	2
	Egypt	0.3	25.4	-3.2%	-3.7	15.4	na	27.3	-15.5	-	-	3
	Czech Republic	1.5	3.0	-5.6%	1.7	0.4	12.2	50.4	6.9	63.9	65%	3
	Hungary	0.0	5.0	-7.4%	5.0	3.3	12.4	109.2	-11.7	75.0	148%	4
	Turkey	-0.4	8.6	-3.1%	-4.5	10.1	13.9	74.5	39.3	25.7	56%	5
	Greece	-1.3	4.0	-2.9%	0.7	7.7	na	115.9	26.7	15.3	259%	5
	South Africa	-0.6	9.3	3.3%	-4.3	8.6	16.0	71.8	-6.4	27.1	45%	6
	Russia	0.1	22.1	20.0%	5.0	9.5	20.6	75.5	17.0	39.1	45%	6
LatAm	Mexico	-0.4	11.2	0.2%	-2.4	6.2	10.4	37.5	7.0	41.7	37%	2
	Peru	-0.7	9.7	5.8%	-3.7	7.0	8.5	34.0	8.3	48.6	34%	4
	Colombia	-0.4	16.4	6.9%	-6.2	8.4	18.5	52.7	15.0	36.3	39%	5
	Chile	-0.8	19.4	9.8%	-0.7	5.5	10.7	109.4	9.3	42.7	62%	6
	Brazil	-1.8	11.7	0.3%	-4.0	15.7	19.9	76.1	26.3	24.5	40%	6

Source: Bloomberg, IMF, BIS, Comtrade, CEIC, Nomura Strategy

Indeed at the *equity* market level rather than the macroeconomic level, Asian listed-company capitalization (both Japanese and ex-Japan) features a higher percentage of downstream (i.e. commodity consuming) sectors, vs. Latam's and EEMEA's disproportionately more *upstream*-skewed (i.e. commodity *producing*) sectors (Figure 155) – again pointing to structural medium-term relative-return advantages for Asia ex-Japan relative to other GEMs:

Fig. 155: Key global equity markets: upstream/downstream sector intensity

(% market capitalization)

	US	Europe	Japan	APxJ	EEMEA	LatAm
Upstream Exposure						
Aluminum	0.1	0.1	-	0.1	-	-
Steel	0.1	0.2	1.1	0.7	0.7	3.3
Diversified Metals & Mining	0.0	1.3	0.3	1.9	1.9	3.4
Gold	0.0	0.1	-	0.2	0.8	-
Coal & Consumable Fuels	0.0	-	-	0.4	0.1	-
Oil & Gas Exploration & Production	1.7	0.1	0.3	1.3	2.8	-
Integrated Oil & Gas	2.1	3.2	-	0.6	7.5	2.5
Agricultural Products	0.2	-	-	0.4	-	-
Tobacco	1.5	2.1	1.4	0.7	-	-
	5.6	**7.0**	**3.1**	**6.3**	**13.7**	**9.2**
Downstream Exposure						
Industrials	9.6	11.2	18.7	8.6	4.1	5.5
Autos	1.2	3.3	14.2	3.1	0.3	-
Tech Hardware	6.1	1.0	7.7	7.5	-	-
Semiconductors	2.5	0.9	0.5	4.5	-	-
Oil & Gas Refining & Marketing	1.6	3.1	0.5	1.9	7.7	3.6
Utilities	2.7	3.9	2.5	3.9	1.8	4.2
	23.7	**23.5**	**44.0**	**29.5**	**13.9**	**13.4**
Net Downstream - Upstream Exposure	**18.1**	**16.5**	**40.9**	**23.2**	**0.2**	**4.2**
Downstream/Upstream Ratio	**4.2**	**3.4**	**14.3**	**4.7**	**1.0**	**1.5**

Source: Datastream, Nomura Strategy

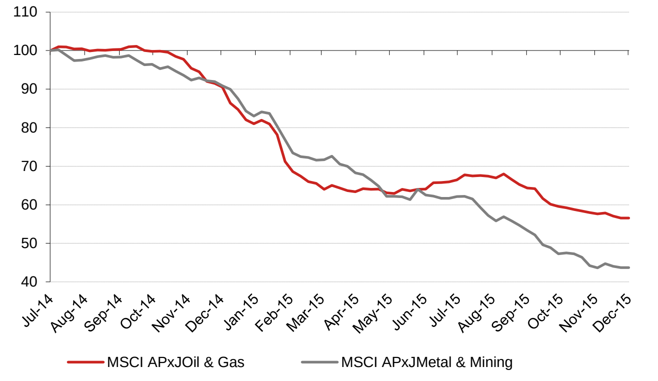
As we first *detailed as early as May 2013*, the benefits of the commodity / energy reset will not be universal, nor uniformly distributed: Lower commodity prices effect a transfer of income from net commodity-exporting to -importing countries through a shift in the terms of trade (i.e. the price of exports relative to the price of imports).

- In the equity space, downward pressure on commodity and energy prices ushers top-line revenue (and thus also earnings-) slippage in equity markets dominated by upstream-sector (i.e. primary industry) activity — such as Metals & Mining and Oil & Gas Exploration & Production (see Figure 155 above).
- Yet falling energy and other factor input prices lowers the cost of manufacturing production, with substantial potential flow-through benefits to bottom-line profitability in secondary-industry (i.e. downstream) sectors such as Manufacturing, Refining &

Petrochemicals, and Power Generation — also an eventual positive for business investment in those sectors.

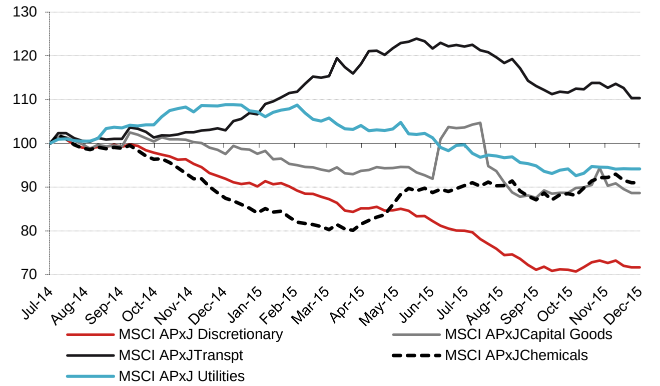
- In that context, we note that upstream extractive industries have suffered considerably greater 12-month forward earnings consensus downgrades, at around 45%-55% since mid-2014 than have the downstream commodity consuming industries (Figures 156 and 157). Indeed most *directly* downstream Asia-Pacific ex-Japan sectors have suffered no more than a (net) 10% earnings downgrade over the same time horizon – and all of which are now stable-to-rising, vs. continued downgrades in the upstream/extractive spaces:

Fig. 156: APxJ 12m fwd EPS revision — upstream sectors
(July 2014 = 100)



Source: Datastream, Nomura Strategy

Fig. 157: APxJ 12m fwd EPS revision — downstream sectors
(July 2014 = 100)



Source: Datastream, Nomura Strategy

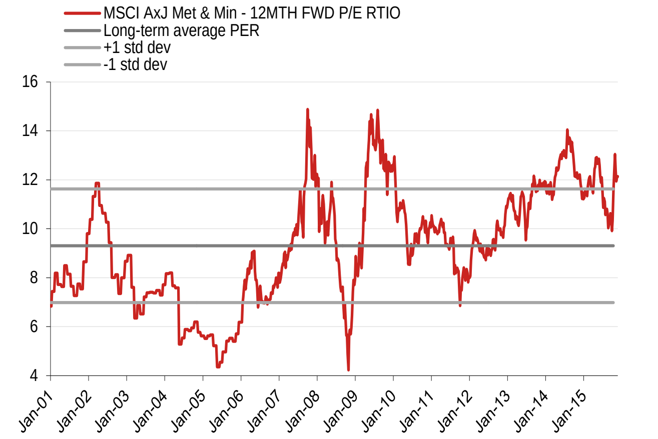
Remain Underweight upstream resource sectors

With this, we prefer to remain *sellers into* rallies in the Asia-Pacific ex-Japan Metals & Mining and Oil & Gas equity spaces in 2016 rather than dip-buyers or 'value'-hunters (our recommended allocation remains *Underweight upstream extractive industries*).

By our reckoning, the mere *stabilization* of metals & energy prices at current low levels would not reveal attractive value in the corresponding equity sectors: Because of deeply downgraded earnings expectations, aggregate PERs in these spaces in fact stand at multiple-standard-deviation *premiums*. And while PBVs *are* at historic discounts — indeed to well below book value for Metals & Mining stocks — massively deteriorated ROEs arguably *validate* those discounts, suggesting possible 'value traps' that may prove sticky:

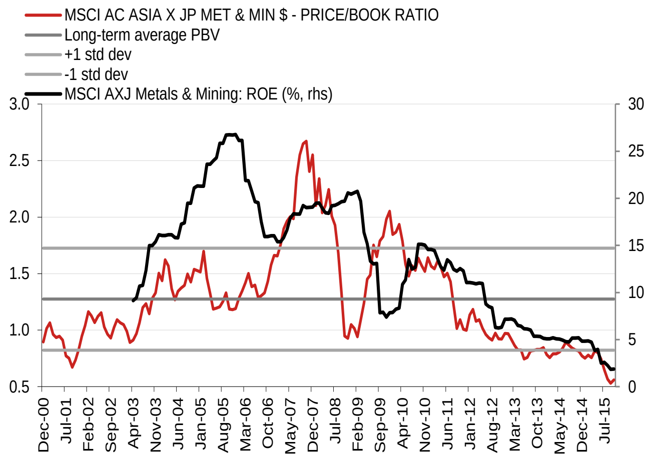
- At a forward PER of 12.1x, MSCI Asia ex-Japan Metals & Mining stocks in aggregate currently sell at a +27% (or 1.1 standard-deviation) *premium* to their post-2001 average of 9.6x (Figure 158). And while the sector-wide PBV *is* at a significant discount (-59%, -1.6 std devs) at 0.5x, this discount reflects ROEs that have collapsed to *just 1.9%* — more than *-11ppt* below their 12-year average (*not* peak) of 13.5% (Figure 159):

Fig. 158: MSCI AC Asia ex-Japan Metals & Mining: 12-month forward PER



Source: Datastream, Nomura Strategy

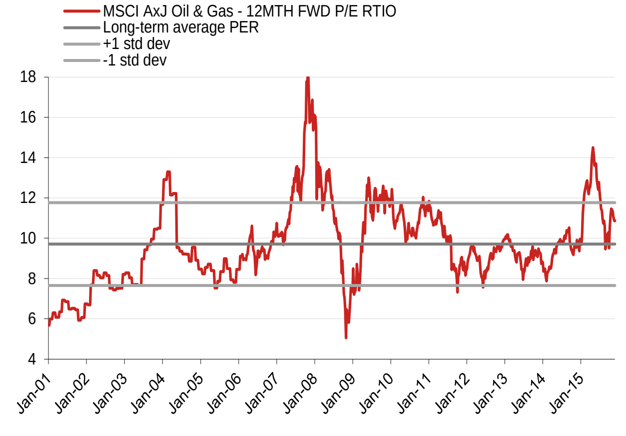
Fig. 159: MSCI AC Asia ex-Japan Metals & Mining: trailing PBV and ROE



Source: Datastream, Nomura Strategy

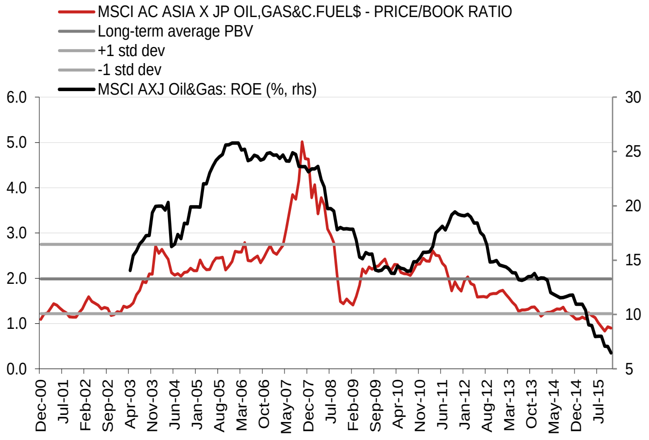
- Similarly, at forward PER of 10.9x, the Asia ex-Japan Oil & Gas sector is at a +12% (or 0.6 standard-deviation) premium to its post-2001 average of 9.7x (again due to earnings forecasts having been decimated). And while the sector-wide PBV is also at a significant discount (-55%, -1.4 std devs) at 0.9x, this PBV discount reflects ROEs that, too, have collapsed — to just 6.5%, i.e. also more than -11ppt below their 12-year average (again, not peak) of 17.6% (Figures 160 and 161):

Fig. 160: MSCI AC Asia ex-Japan Oil & Gas: 12-month forward PER



Source: Datastream, Nomura Strategy

Fig. 161: MSCI AC Asia ex-Japan Oil & Gas: trailing PBV and ROE



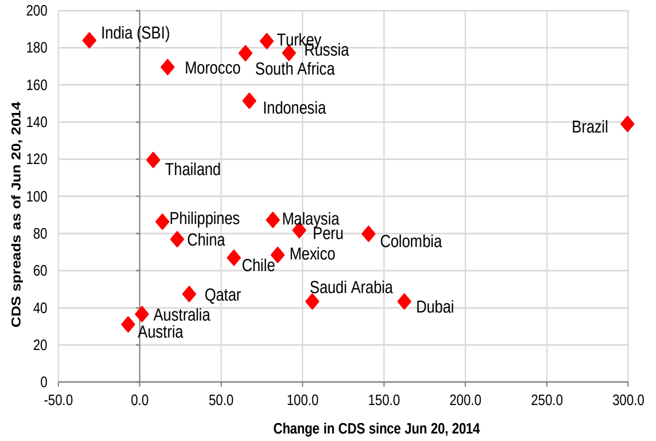
Source: Datastream, Nomura Strategy

While the shallow pace of expected Fed tightening and the pressure-venting effect of a floating exchange-rate global regime (as discussed above) may help mitigate risks of a late-1990s style major/binary EM default event, we continue to regard *global commodity producers and exporters* (i.e. LatAm, Russia, South Africa, Indonesia, Malaysia) as crucial market barometers. For now, reassuringly, CDS spreads even among the commodity-intense EM sovereigns are not (yet) flashing dire signals:

- Among EMs, only Brazil, Dubai, Colombia and Saudi Arabia have suffered CDS spread widenings of even 100bp or more (net) since oil prices and the CRB commodity index started falling in June 2014 (Brazil being the stand-out worst at ~300bp — Figure 162).
- Other LatAm CDS spread widenings (i.e., Peru, Mexico and Chile), along with Russia, Turkey, South Africa, Malaysia and Indonesia, have also been non-negligible at 50-100bp, but fall short of serious default risk thus far. Indeed even the highest absolute CDS spreads among the EMs — i.e., those of Brazil and Russia — remain well below their more distressed levels of the past 10 years (Figure 163):

Fig. 162: Commodity/Energy-producer sovereign CDS spread moves since June 2014

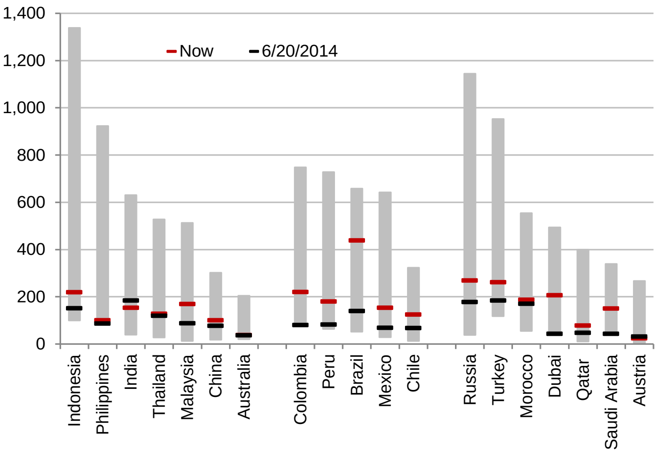
(bps)



Source: Datastream, Nomura Strategy

Fig. 163: Commodity/Energy-producer sovereign CDS spread vs. June 2014 level and post-2004 range

(bps)



Source: Datastream, Nomura Strategy

Box 16: A year of thriving dangerously: Equities and Asian military spending

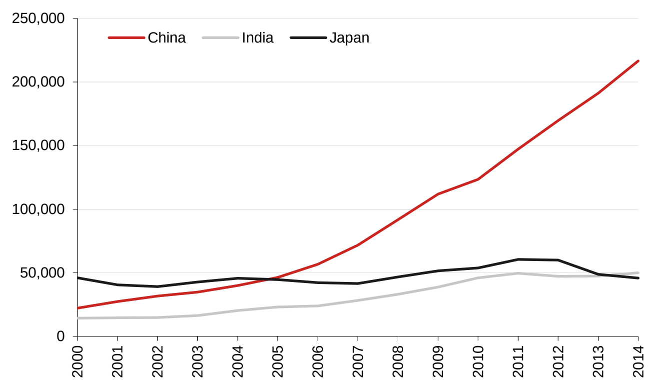
Since we first explored the topic of *equity exposure to Asian military tension/arms spending* in June 2012, regional geopolitical tensions have continued to build: Among other developments, the past year brought news of accelerated Chinese land reclamation efforts and structure-building on eight disputed maritime features in the South China Sea, US Navy 'Freedom of Navigation Operations' in the same area in October, Beijing's elaborate September 3 military parade commemorating the end of the Second World War, and Japan's passing two weeks later of new security legislation opening the country's pacifist constitution to reinterpretation – all offering continuing reminders to equity markets that the Asia-Pacific region (including Russia) remains a militarized and militar*izing* region.

Indeed with the exception of Japan, *all* other major Asia-Pacific countries have increased their military spending in US dollar terms over the five years over 2009-14, by an average 48% over that full five-year period (and at an aggregate US-dollar CAGR of 9%). Even Japan's seeming decline in spending is merely a currency translation effect; in JPY terms Tokyo's military spending is essentially flat vs. 2009 (i.e. up 0.8%). The most notable five-year military spending CAGRs by country are playing out in Indonesia (16%), Vietnam (12%) and Pakistan (10%), while the largest absolute y-y increases in 2014 came in Korea and India (both by roughly US$2.6-2.7bn – see Figures 164 and 165).

Most of all, though, with China's spectacular economic growth over the last decade, its own military expenditure – at least the 'visible' portion of it, now second only to the US globally – has expanded at a CAGR of 14% during 2009-14, and now exceeds the next-largest (i.e. Japan) in absolute terms by more than four-to-one (vs. parity ten years ago). Looking ahead, defence consultants IHS Jane's forecast China's military budget to nearly double by the end of this decade; this would no doubt put tremendous pressure on regional neighbours to sustain military spending increases of their own.

Fig. 164: Asia-Pacific annual defense spending

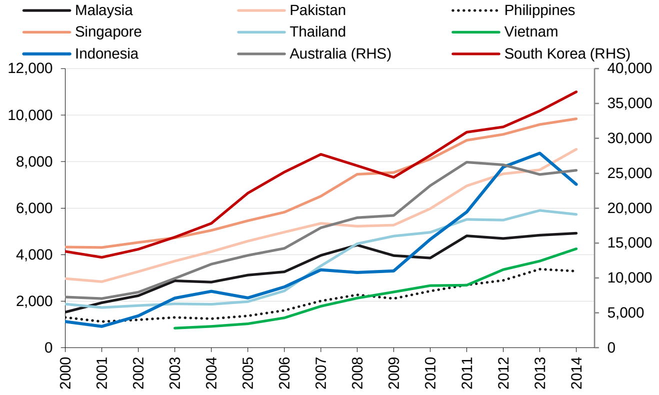
US$mn



Source: World Bank, Nomura Strategy

Fig. 165: Asia-Pacific annual defense spending

US$mn



Source: World Bank, Nomura Strategy

Given the backdrop of rising military tensions and defense budgets, the constituents of the *'Asian Arms Race' equity basket* that we introduced in Aug. 2013 – a list of likely beneficiaries among publicly listed Asia- Pacific ex-Japan defense contractors plus two of the predominant Japanese defense contractors – have collectively posted superlative 43% YTD returns on an equal-weighted basis (USD terms – Figure 167 below), leaving the MSCI Asia-Pacific benchmark's -3.4% performance far behind.

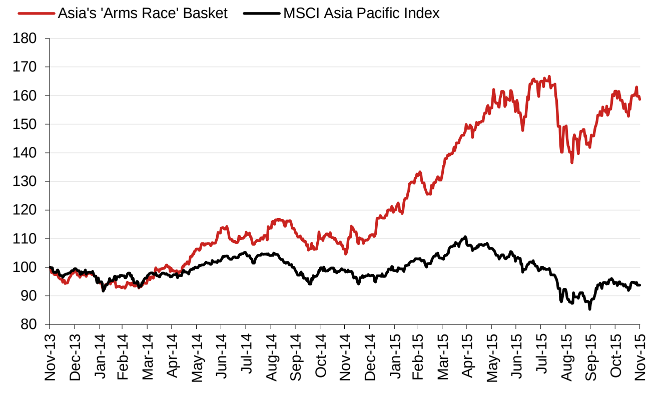
Fig. 166: Nomura 'Asian Arms Race Basket': Key prospective listed beneficiaries of Asia-Pacific defence spending

Ticker	Name	Country	Market Cap US$ mn	Beta	Nomura Rating	Upside to TP
ASB AU	Austal Ltd	Australia	611	(0.01)	Not Rated	na
601989 CH	China Shipbuilding Industry Co	China	28,869	1.3	Not Rated	na
000768 CH	AVIC Aircraft Co Ltd	China	10,710	1.0	Not Rated	na
BHE IN	Bharat Electronics Ltd	India	4,527	1.4	Not Rated	na
PIPV IN	Pipavav Defence & Offshore Eng	India	718	0.7	Not Rated	na
7011 JP	Mitsubishi Heavy Industries Lt	Japan	17,273	1.2	Neutral	-3%
6355 JP	Sumitomo Precision Products Co	Japan	206	0.8	Not Rated	na
STE SP	Singapore Technologies Enginee	Singapore	6,287	0.9	Not Rated	na
012450 KS	Hanwha Techwin Co Ltd	South Korea	1,654	1.0	Not Rated	na
000880 KS	Hanwha Corp	South Korea	2,356	1.6	Not Rated	na
003570 KS	S&T Dynamics Co Ltd	South Korea	428	0.5	Not Rated	na
047810 KS	Korea Aerospace Industries Ltd	South Korea	7,063	1.2	Not Rated	na

Source: Bloomberg, Nomura Strategy

Prices as of 30 November, 2015

Fig. 167: Nomura 'Asian Arms Race Basket' performance



Source: Bloomberg, Nomura Strategy

Fig. 168: Valuation and consensus earnings estimates by MSCI country and sector

	Consensus 12-mo. Forward PER: Curr. Value	Consensus 12-mo. Forward PER: L-term Avg.	Consensus 12-mo. Forward PER: Prem/Disc vs. L-term Avg.	Consensus 12-mo. Forward PER: Standard Deviation	Consensus EPS Growth: FY0	Consensus EPS Growth: FY1	Consensus EPS Growth: FY2	FY1 EPS: 4-wk Revision	FY1 EPS: 8-wk Revision	FY2 EPS: 4-wk Revision	FY2 EPS: 8-wk Revision	PBV: Curr. Value	PBV: L-term Avg.	PBV: Prem/Disc vs. L-term Avg.	PBV: Standard Deviation	ROE: Curr. 12-mo. Trailing	ROE: L-term Avg.
MSCI World	15.4	14.3	**8.0%**	0.5	3.9%	**-0.3%**	7.7%	-0.4%	-0.4%	-1.0%	-1.9%	2.1	2.2	**-3.0%**	-0.2	**11.3%**	12.3%
US	17.0	15.3	**10.6%**	0.6	5.4%	**0.1%**	8.0%	1.4%	1.9%	0.8%	0.0%	2.8	2.7	**6.4%**	0.4	**13.6%**	13.9%
Europe	15.4	13.3	**15.6%**	0.7	1.1%	**-1.7%**	6.5%	-3.3%	-4.6%	-3.8%	-6.3%	1.8	2.0	**-6.1%**	-0.3	**10.0%**	12.7%
UK	15.4	13.7	**12.6%**	0.4	-3.3%	**-15.8%**	4.5%	-0.6%	-2.0%	-1.2%	-3.8%	1.8	2.0	**-11.2%**	-0.6	**10.8%**	14.9%
Japan	14.6	17.2	**-14.8%**	-0.5	5.2%	**18.3%**	7.5%	-0.5%	-1.4%	-0.3%	-1.3%	1.4	1.5	**-4.1%**	-0.2	**8.5%**	5.7%
MSCI EM	10.9	10.7	**2.1%**	0.2	-0.1%	**-2.3%**	9.4%	-1.5%	-0.4%	-2.0%	-1.3%	1.4	1.9	**-24.4%**	-1.2	**10.7%**	13.5%
Asia Pac ex. Japan	12.1	12.4	**-2.8%**	-0.2	5.2%	**0.3%**	5.7%	-1.4%	-0.1%	-1.8%	-1.0%	1.4	1.9	**-22.9%**	-1.3	**11.2%**	12.6%
Asia ex. Japan	11.4	12.0	**-4.8%**	-0.4	4.2%	**2.9%**	7.7%	-1.5%	-0.3%	-2.0%	-1.2%	1.3	1.9	**-30.6%**	-1.5	**11.2%**	12.5%
Australia	15.2	14.0	**8.6%**	0.7	-4.4%	**-7.8%**	7.6%	-0.8%	-2.6%	-1.0%	-3.0%	1.7	2.2	**-20.2%**	-1.1	**11.4%**	13.0%
MSCI China	9.2	11.7	**-21.0%**	-0.9	5.4%	**1.6%**	7.5%	-1.2%	-1.3%	-1.5%	-2.5%	1.3	2.1	**-37.9%**	-1.1	**12.9%**	14.5%
Shanghai A	13.6	14.4	**-5.5%**	-0.1	4.8%	**5.5%**	10.0%	-0.2%	0.8%	-1.0%	-0.9%	2.0	2.6	**-22.9%**	-0.5	**11.5%**	12.0%
Shenzhen A	30.5	19.5	**56.9%**	1.2	7.0%	**34.5%**	30.2%	-1.8%	-3.2%	-0.9%	-2.7%	4.5	3.2	**39.6%**	1.1	**9.1%**	8.8%
HK	14.3	15.4	**-7.6%**	-0.7	7.2%	**-10.8%**	8.6%	-0.5%	-1.7%	-1.0%	-2.0%	1.2	1.5	**-19.6%**	-1.0	**10.4%**	9.1%
India	17.0	14.3	**18.7%**	0.9	3.2%	**8.5%**	18.6%	-1.5%	-2.4%	-1.8%	-3.3%	3.1	3.2	**-3.3%**	-0.1	**13.9%**	18.0%
Indonesia	14.4	11.0	**30.7%**	1.0	8.2%	**-6.3%**	10.3%	-3.4%	-5.0%	-4.0%	-6.3%	2.8	3.3	**-14.0%**	-0.5	**17.9%**	22.7%
Korea	10.3	9.2	**11.8%**	0.7	-9.6%	**16.1%**	6.2%	1.7%	-0.3%	0.4%	-0.9%	1.0	1.4	**-26.5%**	-1.3	**7.9%**	11.6%
Malaysia	15.2	14.3	**6.1%**	0.7	-5.3%	**-3.3%**	7.9%	-0.5%	-0.1%	-0.4%	-1.2%	1.7	2.0	**-12.4%**	-0.9	**9.9%**	11.9%
New Zealand	18.8	14.8	**27.2%**	2.0	1.5%	**5.6%**	8.0%	-1.1%	-0.9%	-0.3%	0.0%	1.7	2.1	**-16.8%**	-0.6	**8.4%**	12.5%
Philippines	17.7	15.0	**18.0%**	1.0	7.7%	**7.0%**	11.7%	-0.6%	-1.2%	-0.6%	-1.3%	2.7	2.2	**21.4%**	0.6	**13.6%**	12.1%
Singapore	11.8	14.2	**-16.3%**	-1.2	8.9%	**-2.6%**	4.9%	-1.1%	-2.1%	-2.4%	-4.2%	1.2	1.6	**-30.0%**	-1.7	**9.3%**	11.6%
Taiwan	12.1	14.0	**-13.6%**	-0.6	25.9%	**1.3%**	4.4%	-2.8%	-2.8%	-2.1%	-2.9%	1.7	1.9	**-10.6%**	-0.8	**14.2%**	10.2%
Thailand	12.4	10.9	**14.4%**	1.1	-6.0%	**4.5%**	12.4%	-2.3%	-3.4%	-2.3%	-3.4%	1.9	2.1	**-10.3%**	-0.6	**11.9%**	15.1%
LatAm	12.2	10.6	**14.9%**	0.9	-5.8%	**-16.3%**	22.4%	1.8%	2.5%	-1.1%	1.7%	1.5	2.0	**-21.9%**	-0.9	**7.8%**	13.9%
Brazil	10.3	8.7	**18.2%**	0.7	-6.3%	**-28.8%**	25.7%	-0.6%	-2.7%	-5.7%	-4.6%	1.2	1.7	**-33.5%**	-1.1	**7.1%**	14.5%
Chile	12.7	15.5	**-17.6%**	-1.5	3.8%	**11.2%**	23.7%	-1.1%	-4.2%	0.5%	-1.7%	1.5	1.9	**-21.8%**	-0.9	**7.8%**	9.3%
Colombia	12.0	14.7	**-18.5%**	-0.4	-16.3%	**-1.2%**	14.0%	7.1%	9.3%	11.3%	10.1%	1.1	1.7	**-35.9%**	-1.0	**6.6%**	9.2%
Mexico	17.7	13.7	**29.4%**	1.5	-12.4%	**9.1%**	22.6%	-2.8%	-5.8%	-2.9%	-4.8%	2.7	2.7	**-0.9%**	0.0	**9.5%**	15.2%
Peru	10.9	11.8	**-7.5%**	-0.2	54.6%	**-10.9%**	10.7%	1.0%	1.2%	0.8%	-0.1%	1.5	3.1	**-49.5%**	-1.1	**12.8%**	20.6%
EMEA	9.5	9.4	**0.9%**	0.1	-7.3%	**-17.5%**	8.5%	-3.1%	-3.2%	-3.0%	-4.7%	1.3	1.8	**-30.5%**	-1.0	**9.8%**	14.8%
Czech Republic	12.3	12.2	**1.3%**	0.1	-21.1%	**10.0%**	-9.2%	-0.5%	-0.5%	-1.4%	-2.4%	1.3	1.8	**-25.9%**	-0.6	**9.9%**	12.9%
Egypt	8.6	9.8	**-12.9%**	-0.4	-17.8%	**96.2%**	25.4%	-0.2%	-0.4%	-0.5%	-2.3%	1.8	2.7	**-33.4%**	-0.5	**10.1%**	17.3%
Greece	6.4	12.3	**-47.9%**	-1.4	-108.6%	**na**	178.6%	-15.0%	-16.4%	8.0%	5.0%	0.5	1.9	**-74.2%**	-1.5	**-18.1%**	9.0%
Hungary	11.7	9.4	**23.3%**	1.4	-45.7%	**41.9%**	30.6%	2.1%	0.8%	1.6%	2.3%	1.2	1.8	**-30.1%**	-0.7	**12.9%**	15.0%
Poland	11.2	12.1	**-7.4%**	-0.5	-12.8%	**26.3%**	-9.3%	-1.8%	-1.4%	-3.7%	-5.4%	1.1	1.7	**-34.1%**	-1.2	**10.1%**	12.2%
Qatar	11.2	13.9	**-19.6%**	-0.6	1.4%	**-1.5%**	9.8%	-2.6%	-1.1%	-2.6%	-1.6%	1.7	2.4	**-29.3%**	-0.5	**14.1%**	15.7%
Russia	5.1	7.0	**-27.0%**	-0.8	-3.3%	**-40.1%**	4.2%	-4.5%	-6.5%	-5.3%	-9.9%	0.7	1.3	**-49.8%**	-1.1	**8.5%**	15.4%
South Africa	15.0	11.0	**36.2%**	1.9	7.4%	**2.7%**	10.3%	-0.9%	-1.4%	-0.3%	-1.4%	2.4	2.5	**-0.6%**	0.0	**13.6%**	16.5%
Turkey	8.6	9.3	**-7.1%**	-0.4	-1.4%	**7.5%**	16.4%	0.4%	-1.3%	0.6%	-0.6%	1.3	1.9	**-31.5%**	-1.1	**13.3%**	15.5%
UAE	10.2	13.8	**-26.2%**	-0.9	12.4%	**-4.1%**	16.8%	-1.2%	-0.7%	-2.5%	-4.6%	1.3	1.6	**-20.9%**	-0.3	**11.4%**	10.4%
By sector - AEJ																	
Auto & Compo	8.1	8.5	**-5.2%**	-0.3	-6.6%	**-3.6%**	12.0%	-1.3%	1.7%	-1.0%	3.6%	1.2	1.6	**-26.1%**	-0.9	**12.7%**	16.2%
Banks	7.3	10.6	**-31.7%**	-1.6	7.5%	**1.9%**	3.8%	-1.3%	-0.1%	-2.3%	-1.8%	1.0	1.6	**-40.6%**	-2.0	**12.7%**	12.8%
Cap Gds	12.2	13.2	**-7.4%**	-0.4	1.0%	**-6.9%**	18.4%	1.8%	4.3%	-3.8%	-3.6%	1.2	1.5	**-18.6%**	-0.6	**8.2%**	9.9%
Energy	11.1	9.7	**14.4%**	0.7	-19.7%	**-19.5%**	11.7%	-2.4%	-2.8%	-2.8%	-4.9%	0.9	2.0	**-54.2%**	-1.4	**6.5%**	17.7%
Fd/Bev/Tob	18.4	14.6	**26.1%**	1.2	2.4%	**9.3%**	13.5%	-4.9%	-3.1%	-4.9%	-3.1%	2.4	2.4	**-2.8%**	-0.1	**9.6%**	14.9%
Healthcare	24.1	18.4	**30.8%**	1.6	9.9%	**19.4%**	30.5%	-1.5%	-1.1%	0.8%	2.0%	4.7	3.9	**20.7%**	0.9	**14.2%**	16.1%
Insurance	13.6	16.5	**-18.1%**	-0.7	32.1%	**30.3%**	3.7%	-0.3%	-0.2%	-0.4%	-0.7%	1.9	2.7	**-28.6%**	-1.0	**14.2%**	10.9%
Materials	13.0	10.2	**27.3%**	1.3	-14.5%	**13.0%**	26.6%	-4.5%	-11.5%	-3.9%	-4.8%	1.0	1.5	**-31.7%**	-1.2	**5.3%**	13.8%
Real Estate	11.1	14.4	**-22.9%**	-1.1	4.6%	**-6.5%**	11.8%	-2.0%	-1.7%	-0.5%	-0.5%	0.8	1.0	**-26.2%**	-0.9	**8.4%**	7.2%
Retailing	14.6	14.4	**1.8%**	0.1	-1.3%	**11.4%**	8.3%	-3.3%	-2.7%	-3.3%	-1.8%	1.4	2.9	**-51.9%**	-1.5	**7.3%**	15.7%
Software & Services	24.0	20.4	**17.7%**	1.0	29.3%	**14.6%**	21.7%	-2.3%	-1.1%	-2.3%	-1.5%	7.3	7.3	**-0.2%**	0.0	**23.6%**	28.0%
Tech Hardware & Equip	10.2	12.8	**-21.0%**	-0.7	-7.2%	**-8.4%**	8.9%	-3.1%	1.0%	-0.9%	1.8%	1.2	1.9	**-39.4%**	-1.6	**11.6%**	10.4%
Telecom	14.6	13.2	**10.8%**	0.6	-1.8%	**6.6%**	5.9%	-1.0%	1.2%	-1.2%	0.2%	2.0	2.4	**-18.7%**	-0.8	**12.1%**	15.8%
Transpt	15.8	14.4	**9.3%**	0.3	20.1%	**27.0%**	29.1%	-7.5%	-11.2%	-4.1%	-4.7%	1.4	1.4	**1.1%**	0.0	**6.9%**	8.6%
Utilities	10.7	12.6	**-14.5%**	-0.8	22.5%	**52.7%**	-15.7%	2.8%	6.3%	1.4%	2.9%	1.4	1.5	**-4.5%**	-0.3	**11.0%**	9.8%
By sector - Global																	
Autos	10.0	17.4	**-42.8%**	-0.1	6.2%	**11.2%**	11.7%	-2.1%	-1.4%	-1.1%	-1.6%	1.5	1.5	**3.6%**	0.2	**13.5%**	10.4%
Banks	10.1	11.1	**-8.6%**	-0.6	2.1%	**14.8%**	6.1%	0.1%	-0.4%	-0.8%	-2.2%	1.0	1.6	**-33.3%**	-1.1	**8.9%**	11.2%
Capital Goods	15.9	14.7	**7.9%**	0.5	3.5%	**-0.5%**	8.5%	-1.0%	-1.4%	-2.1%	-3.9%	2.5	2.3	**6.8%**	0.4	**12.8%**	13.4%
Comm Prof Svs	18.9	17.3	**9.0%**	0.6	7.5%	**7.8%**	7.5%	-1.3%	-0.7%	-2.0%	-1.9%	3.7	3.1	**17.7%**	0.8	**16.7%**	14.6%
Consumer Dur/App	17.6	16.8	**4.8%**	0.3	-7.7%	**22.9%**	15.4%	-1.7%	-2.0%	-1.9%	-2.6%	2.9	2.0	**43.7%**	2.1	**12.2%**	8.5%
Consumer Svs	20.8	17.4	**19.7%**	1.6	4.3%	**4.9%**	14.1%	0.3%	1.3%	-0.1%	0.1%	5.2	3.3	**60.4%**	2.2	**20.3%**	16.8%
Div Fin	13.4	12.1	**10.3%**	0.6	7.4%	**7.8%**	9.1%	0.5%	-1.6%	-0.2%	-3.0%	1.5	1.6	**-9.7%**	-0.3	**9.9%**	9.1%
Energy	18.6	12.2	**53.3%**	2.5	-1.4%	**-50.3%**	4.7%	0.4%	-1.4%	0.1%	-5.7%	1.2	2.2	**-42.1%**	-1.5	**5.4%**	16.8%
Food/Bev/Tob	20.8	16.1	**29.3%**	2.6	6.4%	**-1.4%**	7.9%	-1.8%	-1.3%	-1.6%	-1.2%	4.6	3.8	**19.6%**	1.7	**19.6%**	21.2%
Food/Drug Rtl	18.2	16.2	**11.8%**	0.8	-4.0%	**2.6%**	6.5%	-2.1%	-0.9%	-3.6%	-4.9%	2.8	2.8	**-1.4%**	-0.1	**14.0%**	14.2%
Healthcare Eq/Svs	17.5	16.5	**6.4%**	0.3	11.6%	**5.7%**	12.1%	0.3%	0.5%	0.3%	0.3%	3.3	3.2	**4.4%**	0.2	**14.0%**	15.6%
HH Pers Prd	22.1	18.9	**17.3%**	1.2	3.5%	**0.8%**	3.6%	-1.4%	-1.2%	-1.3%	-1.7%	5.5	5.0	**9.5%**	0.3	**21.2%**	21.8%
Insurance	12.0	11.4	**5.0%**	0.2	9.5%	**4.8%**	5.5%	-1.2%	-1.8%	-0.8%	-1.6%	1.3	1.5	**-11.6%**	-0.4	**9.8%**	9.0%
Materials	15.3	13.0	**17.6%**	1.0	-1.1%	**-18.2%**	10.0%	-1.8%	-5.2%	-3.2%	-7.6%	1.6	2.0	**-19.7%**	-1.0	**8.5%**	12.6%
Media	19.0	20.9	**-9.1%**	-0.2	-28.9%	**11.2%**	15.3%	-0.6%	-0.3%	-1.0%	-1.3%	3.5	2.2	**56.0%**	1.7	**14.6%**	11.1%
Pharm/Biotec	17.2	16.0	**7.3%**	0.3	10.7%	**12.2%**	8.4%	0.2%	1.6%	-1.0%	-0.2%	4.2	4.1	**3.1%**	0.1	**15.8%**	18.4%
Real Estate	21.6	19.5	**10.6%**	0.7	5.5%	**2.7%**	2.4%	-1.5%	0.1%	-0.9%	-0.8%	1.6	1.4	**11.3%**	0.5	**8.1%**	6.8%
Retailing	23.7	17.8	**33.1%**	1.8	12.6%	**11.6%**	15.8%	-0.7%	0.3%	-1.1%	0.3%	6.2	3.5	**77.4%**	2.8	**21.9%**	16.6%
Semiconductor	15.5	19.5	**-20.5%**	-0.1	49.6%	**0.1%**	3.8%	0.5%	3.1%	0.0%	0.5%	3.1	2.8	**8.9%**	0.3	**19.0%**	13.4%
Software & Svs	21.2	19.8	**7.3%**	0.3	10.0%	**2.0%**	12.8%	0.7%	1.1%	0.3%	0.8%	5.2	4.5	**16.9%**	1.1	**19.0%**	19.2%
Tech Hardware	12.1	18.0	**-32.6%**	-0.7	9.5%	**8.2%**	5.7%	1.4%	1.7%	0.7%	0.1%	2.3	2.7	**-16.7%**	-0.8	**16.7%**	12.9%
Telecom	14.9	18.0	**-17.3%**	-0.4	-5.2%	**7.8%**	6.4%	-1.3%	-0.6%	-1.3%	-1.3%	2.3	1.9	**21.2%**	1.3	**11.0%**	12.3%
Transport	15.3	15.7	**-2.6%**	-0.2	13.2%	**15.9%**	9.4%	-1.5%	-0.8%	-0.9%	-1.5%	2.5	2.1	**20.8%**	1.3	**14.5%**	11.2%
Utilities	13.9	13.7	**1.8%**	0.2	2.2%	**9.3%**	-3.4%	-0.1%	1.3%	-1.5%	-0.4%	1.5	1.6	**-9.0%**	-0.5	**9.5%**	10.2%

Source: Datastream, Nomura Strategy

Fig. 169: Monthly foreign net purchases of Asian equities

US$mn	Korea	Taiwan	India	Malaysia	Indonesia	Thailand	Philippines	Shanghai ('Stock Connect' only)	Hong Kong ('Stock Connect' only)	Asia Ex-J (9)	Japan
Jan-12	5,439	1,848	2,183		271	96	366			**10,203**	5,972
Feb-12	3,880	2,107	5,131	434	-164	0	152			**11,540**	5,657
Mar-12	329	977	1,552	1,110	988	1,086	-88			**5,955**	4,684
Apr-12	8	-1,001	-103	526	160	38	176			**-196**	1,153
May-12	-3,474	-3,856	-273	158	-820	-470	187			**-8,549**	-4,627
Jun-12	-837	-840	26	-252	-208	-180	873			**-1,419**	-1,545
Jul-12	555	-1,592	2,019	1,054	487	10	505			**3,038**	-2,700
Aug-12	4,465	3,079	1,753	384	45	-67	-68			**9,590**	-448
Sep-12	2,973	2,055	3,845	425	983	107	83			**10,471**	-191
Oct-12	-987	-956	1,967	492	277	-582	-213			**-2**	1,835
Nov-12	-566	1,424	2,001	-99	-319	201	192			**2,833**	6,148
Dec-12	3,299	1,669	4,446	262	13	754	383			**10,825**	18,334
2012	**15,084**	**4,913**	**24,548**	**4,495**	**1,712**	**992**	**2,548**			**54,291**	**34,271**
Jan-13	-1,722	660	4,096	805	589	499	667			**5,593**	9,660
Feb-13	1,760	1,076	4,142	550	1,161	-583	146			**8,252**	10,190
Mar-13	-1,885	-896	1,913	1,550	189	208	204			**1,283**	20,643
Apr-13	-2,583	1,084	951	1,775	74	-681	284			**904**	27,167
May-13	902	2,158	3,771	1,258	-34	-169	448			**8,335**	12,167
Jun-13	-4,491	-3,945	-1,764	-1,108	-2,033	-1,800	-241			**-15,382**	6,835
Jul-13	850	2,757	-986	-92	-253	17	129			**2,422**	9,650
Aug-13	1,958	-1,524	-947	-2,070	-520	-1,262	-425			**-4,790**	-1,440
Sep-13	7,141	4,210	1,994	245	-28	299	-70			**13,792**	8,111
Oct-13	4,734	2,777	2,927	-254	-181	38	-175			**9,867**	4,770
Nov-13	-200	-783	1,130	-962	-336	-1,515	-115			**-2,780**	25,217
Dec-13	-1,589	1,612	2,527	-488	-436	-1,261	-173			**192**	20,331
2013	**4,875**	**9,188**	**19,754**	**1,209**	**-1,806**	**-6,211**	**679**			**27,688**	**153,300**
Jan-14	-1,142	804	-13	-1,076	198	-416	-107			**-1,751**	-10,747
Feb-14	-528	-361	420	-488	659	-653	72			**-880**	-811
Mar-14	-1,034	2,532	3,678	-153	1,272	440	428			**7,163**	-5,716
Apr-14	2,837	3,103	1,211	214	765	492	364			**8,986**	4,078
May-14	1,720	1,283	2,781	965	707	-1,097	209			**6,567**	-810
Jun-14	1,040	2,906	1,840	187	230	-13	47			**6,237**	5,530
Jul-14	4,028	1,114	1,939	-94	1,125	427	1			**8,540**	3,554
Aug-14	1,712	1,604	1,055	32	-112	75	298			**4,663**	-2,549
Sep-14	-537	-1,808	903	-427	-616	657	11			**-1,815**	5,549
Oct-14	-2,004	19	145	-152	-261	-497	-540			**-3,289**	-3,601
Nov-14	1,554	3,300	2,320	-89	434	337	601	7,097	681	**16,234**	10,926
Dec-14	-1,964	-1,306	-117	-858	-634	-843	-129	5,325	1,308	**783**	1,802
2014	5,684	13,190	16,162	-1,939	3,766	-1,091	1,255	12,422	1,990	**51,439**	7,206
Jan-15	-1,033	2,143	2,879	-662	19	-128	528	4,064	2,447	**10,257**	-7,726
Feb-15	1,166	3,199	1,434	-111	830	-213	371	4,225	451	**11,352**	1,660
Mar-15	2,487	-1,114	1,687	-135	-413	84	167	2,195	1,862	**6,821**	4,375
Apr-15	3,966	3,512	1,212	56	-710	7	-203	224	8,843	**16,907**	17,131
May-15	1,748	1,158	-67	-682	-264	94	-201	2,792	2,548	**7,126**	7,677
Jun-15	-971	-2,619	-961	-822	-307	-311	-259	1,818	1,920	**-2,512**	-1,396
Jul-15	-1,695	-1,464	882	-758	10	-773	-193	-4,400	165	**-8,226**	-2,897
Aug-15	-3,626	-1,661	-2,598	-952	-709	-1,248	-380	3,736	930	**-6,508**	-9,510
Sep-15	-1,611	-18	-861	-523	-498	-584	-706	622	842	**-3,338**	-19,707
Oct-15	9	2,117	780	140	-350	5	-67	-313	318	**2,639**	2,183
Nov-15	-1,464	-1,085	-1,149		-243	-403	-168	-1,958	1,486	**-4,985**	5,521
Dec-MTD	-133	258	-13		-45	-10	-4	66	185	**306**	0
(% Mkt Cap) Dec-MTD	**0.0%**	**0.1%**	**0.0%**	**0.0%**	**-0.1%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**-**
2015-YTD	**-1,157**	**4,425**	**3,226**	**-4,449**	**-2,680**	**-3,480**	**-1,114**	**13,072**	**21,996**	**29,839**	**-2,688**
(% Mkt Cap) 2015	**-0.2%**	**1.0%**	**1.1%**	**-3.9%**	**-3.1%**	**-4.7%**	**-2.2%**	**0.3%**	**1.2%**	**0.4%**	**-0.1%**

Note: Japan data subject to one-week delay; Malaysia data available monthly; Shanghai and Hong Kong values reflect 'Stock Connect' flows only

Source: Bloomberg, Nomura Strategy

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Appendix A-1

Analyst Certification

We, Robert Nemmara Subbaraman, Michael Kurtz, Craig Chan, Vivek Rajpal and Albert Leung, hereby certify (1) that the views expressed in this Research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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Dongbu Insurance	005830 KS	KRW 63,700	04-Dec-2015	Buy	Buy	18-Mar-2013	N/A
Samsung Electronics	005930 KS	KRW 1,269,000	04-Dec-2015	Buy	Neutral	03-Jul-2009	N/A
Hyundai Wia	011210 KS	KRW 119,000	04-Dec-2015	Buy	Neutral	27-Apr-2012	N/A
LG Chem	051910 KS	KRW 309,000	04-Dec-2015	Buy	Neutral	09-Sep-2009	N/A
Amorepacific	090430 KS	KRW 407,000	04-Dec-2015	Buy	Neutral	25-Apr-2014	N/A
Shenzhen Int'l	152 HK	HKD 13.24	04-Dec-2015	Buy	Not Rated	22-Apr-2015	N/A
CRRC	1766 HK	HKD 10.32	04-Dec-2015	Buy	Reduce	08-Jul-2015	N/A
Intime Retail (Group)	1833 HK	HKD 7.62	04-Dec-2015	Buy	Reduce	07-Jul-2015	N/A
AAC Technologies	2018 HK	HKD 53.55	04-Dec-2015	Buy	Neutral	25-Aug-2015	N/A
Taiwan Semiconductor Manufacturing Corp.	2330 TT	TWD 140.5	04-Dec-2015	Buy	Neutral	13-Oct-2015	N/A
Quanta Computer	2382 TT	TWD 56.6	04-Dec-2015	Buy	Neutral	21-Jul-2014	N/A
BOC Hong Kong	2388 HK	HKD 24.00	04-Dec-2015	Buy	Not Rated	06-Oct-2015	N/A
China Pacific	2601 HK	HKD 32.75	04-Dec-2015	Buy	Not Rated	01-Sep-2015	N/A
Largan Precision	3008 TT	TWD 2,530.0	04-Dec-2015	Buy	Neutral	05-Nov-2012	N/A
Tencent Holdings	700 HK	HKD 151.00	04-Dec-2015	Buy	Not Rated	05-Mar-2014	N/A
Mitsubishi Heavy Industries	7011 JP	JPY 633.3	04-Dec-2015	Neutral	Buy	04-Mar-2013	N/A
POU CHEN	9904 TT	TWD 42.6	04-Dec-2015	Buy	Not Rated	02-Mar-2015	N/A
Axis Bank	AXSB IN	INR 462	03-Dec-2015	Buy	Rating Suspended	08-Jul-2014	N/A
Bank Mandiri	BMRI IJ	IDR 8,800	03-Dec-2015	Buy	Not Rated	04-Mar-2015	N/A
Container Corporation of India	CCRI IN	INR 1446	03-Dec-2015	Buy	Neutral	28-Sep-2015	N/A
DBS Group Holdings	DBS SP	SGD 16.62	03-Dec-2015	Buy	Neutral	02-Sep-2010	N/A
HCL Technologies	HCLT IN	INR 851	03-Dec-2015	Buy	Neutral	10-Sep-2009	N/A
Malayan Banking	MAY MK	MYR 8.36	03-Dec-2015	Buy	Reduce	30-May-2012	N/A
Maruti Suzuki	MSIL IN	INR 4627	03-Dec-2015	Buy	Neutral	31-Oct-2012	N/A
PT Pembangunan Perumahan	PTPP IJ	IDR 3,770	03-Dec-2015	Buy	Not Rated	03-Feb-2015	N/A
Raffles Medical	RFMD SP	SGD 4.12	03-Dec-2015	Buy	Not Rated	07-Sep-2015	N/A
Robinson Department Store	ROBINS TB	THB 42.50	03-Dec-2015	Buy	Not Rated	11-Jun-2015	N/A

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STOCKS

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