APAC Equity Strategy

China, Japan and the emergence of patronomics

Equity Strategy

Asia Pacific

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China and Japan playing an increasing role as regional economic patrons

China's 'One Belt One Road' policy aims to expand infrastructure overseas. Japan too recently announced US$110bn of regional spending. Projected programmes from China/Japan are 'only' US250bn but this still amounts to 15% of combined Malaysian, Thai, Indonesian and Philippine GDP. Competition between Japanese and Chinese infra consortia is heating up especially in rail investment (see Alice Fulwood's note here). In other areas too, we see evidence of Chinese/Japanese capital flowing into the region, be it lending or FDI or implicit government support. We expect this to grow, especially as Chinese banks' regional lending picks-up. We believe China and Japan look likely to play a greater role as regional economic patrons in the next few years.

ASEAN the major long-term beneficiary of patronomics

While short-term, the Fed is likely to be the key influence on ASEAN markets, longer term these economies sit comfortably in the middle of patronomics and are where we see the most positive potential implications.

Discount rates might benefit from the flow of patro-dollars…

Low cost lending for infrastructure alongside greater involvement from Japanese and Chinese banks might provide lower cost funding than would otherwise be the case as US rates start to rise. And our assumptions on risk premiums may be too high if previous concerns about liquidity in current account deficit countries are off the table with implicit liquidity support (as in Indonesia in 2013) from China/Japan. Higher potential FDI/capital flows from these countries could allow the running of larger current account deficits than would otherwise be possible with rising US rates. To some extent, we believe the flow of 'patro-dollars' might offset some of Debtopia's headwinds over time.

...while potentially supporting growth

ASEAN is currently stuck in a lacklustre economic environment sitting as it is at the top of a credit cycle, and for the commodity producers, facing structurally lower growth support from commodities. The ASEAN Economic Community is due to be established by the end of 2015. Through increasing connectivity in the region, the aim is to boost trade and investment, and in turn prosperity. However, to make a reality of this vision, the ADB had previously estimated it would require investment in hard infrastructure of approximately US$800bn, or 30% of ASEAN's current GDP. Assuming ASEAN leaders had the ability to implement the grand vision, the questions remained how to finance this. This is why we think the patronomic theme is so timely. As Alice's note suggests, the Bangkok-Kunming rail project alone could ultimately be worth 3.7ppts of Thailand's current level of GDP.

Our colleague Alice Fulwood has published a note today exploring [China's Railroad plans for ASEAN]. This ties into a broader theme in Asia of Chinese capital playing a greater role around the region. Over the course of the last year China has among other initiatives:

1. Driven the establishment of the Asian Infrastructure Investment Bank (AAIB), with up to US$100bn of authorised capital (plus the potential to issue debt).

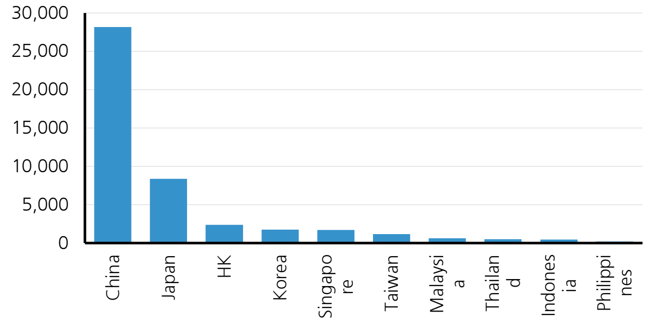
2. Established a Silk Road Fund with US$40bn of capital

This is widely recognised as part of the One Belt, One Road policy that President Xi has articulated, which most publicly has led to the US$46bn China-Pakistan Economic Corridor (this amounts to 0.5% of Chinese GDP, and 17.5% of Pakistan's GDP).

Many initiatives that commit Chinese capital to Asia on the rise

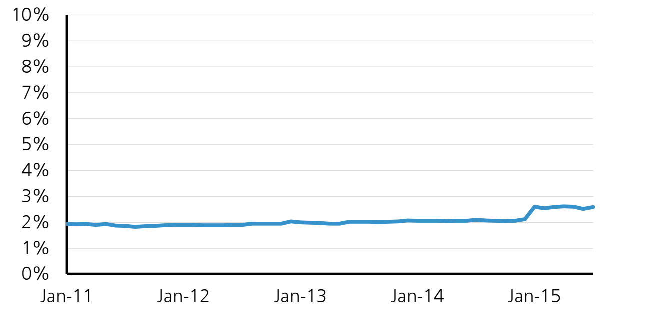
Beyond these direct government involvements, Stephen Andrews and our banks team estimate that the Chinese banking system intends to commit hundreds of billions of US$ to support this initiative. Given the size of the banking system (almost US$30 trillion) versus the rest of the region (by contrast, the total assets of the Indonesian banking system are US$463bn), these are large numbers. We also expect that policy banks in China may commit more to lending, over and above those included in other initiatives.

Figure 1: Relative size of different Asian banking markets, US$ bn at YE14E



Source: Central Banks, CEIC, UBS Banks team

Figure 2: Overseas loans currently make up a fraction of China banking system total loans

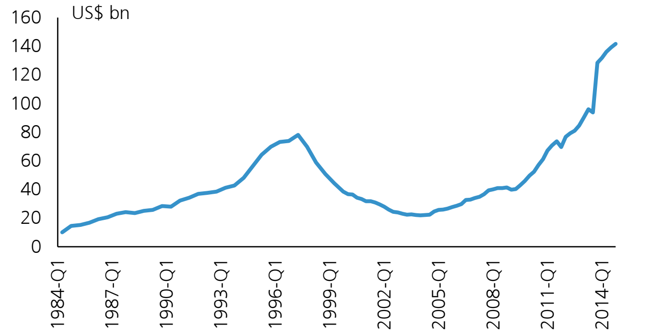


Source: PBOC, UBS Banks team

Japan is similarly announcing intentions to spend capital in Asia

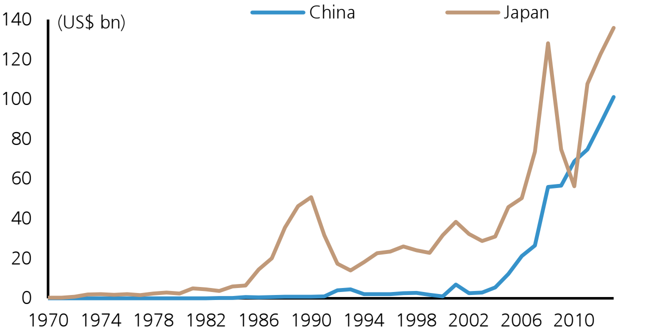
But this is not a China specific theme. In May, the Japanese government, which along with the US is not a founder member of the AIIB, announced its intention to expand assistance to Asian countries (in collaboration with the Asia Development Bank), by providing an additional US$110bn over five years.

Figure 3: Japanese bank lending to ASEAN (Thailand, Malaysia, Indonesia, Philippines) is on the rise



Source: BIS, UBS

Figure 4: China and Japan's outward FDI 1970-2013



Source: UNCTAD

In addition, there is increasing competition between Chinese and Japanese consortia on infrastructure funding within ASEAN. For example, in Indonesia, it was Chinese and Japanese (government backed) entities [1] that were in the final stages of bidding for a proposed high speed rail project between Jakarta and the country's fourth largest city Bandung in West Java (although the deal subsequently was postponed). And In Thailand, the China government backed rail link from Bangkok towards Kunming has been met with stepped up interest by a Japanese consortium in constructing a rail link between Bangkok to Changi-Mai and Bangkok to Dawei on Myanmar's Andaman coast.

Increasing competition between China and Japan from infrastructure projects to trade

Beyond infrastructure, both China and Japan's capital influences and support have been felt in other ways. For example in 2013 during the Tapering sell-off and currency pressure, central banks from both pledged support to Indonesia to ease the strain on FX reserves.

And in other areas, both countries are actively involved in trade promotion with (separate) initiatives on free trade areas. China is pursuing regional investment and trade agreements in the form of i) an upgrade of the ASEAN-China Free Trade Agreement and ii) the completion of the Regional Comprehensive Economic Partnership. Meanwhile, Japan is taking part in the Regional Comprehensive Economic Partnership and the more stringent (US led) Trans Pacific Partnership (TPP).

A new regional order?

Individually, each of these is interesting in its own right, and has important implications for certain sectors in China, Japan and the rest of the region. Our economists and analysts have written separately about many of these over the last couple of years (see appendix for list of research). Taken together however they indicate the role that these two regional economic giants are playing more broadly in Asia Pacific.

China and Japan's role in the region to be large and long lasting

We think this is only likely grow in the coming years as China continues to engage more in the region and on the world stage, and as infrastructure spending picks up driven by separate initiatives.

Because on the infrastructure side these are areas where Japan is already strong, we do not expect Japan to stand aside, with greater government involvement likely (as evidenced by Japan's proposed US$110bn assistance programme).

At present, the collective AIIB, Silk Road Fund, and Japanese government initiative amounts to US$250bn. This is before any gearing up of the AIIB, or commercial and policy bank support in China. We expect these numbers to grow - meaningfully. While not all of this will be directed at one country in the region or in any one year, to put things in context, these sums amount to 15% of aggregate Thai, Indonesian, Philippine and Malaysian GDP.

While from time to time, concerns around domestic matters may of course take these external issues off the front page, we believe that both China and Japan will be playing an ever greater role in the region in part potentially spurred on by each other – in terms of spending, fiscal support, bank capital and trade promotion.

[1] According to the Jakarta Post (3 Sept): i) China offered a joint venture model between state owned enterprises. ii) The Japanese offer was a project 74% funded by loans from the Japanese Government.

We would also expect both to provide economic backstops to more challenging macro liquidity concerns around the region.

In a sense, this can be seen as a form of economic patronage, or patronomics. From it flow some interesting potential implications for the region.

Potential macro implications

The ASEAN region sits comfortably in the middle of this. This is where we see some of the most powerful potential longer-term implications. Generally these are positive in terms of net present value for investors through all three levers of DCF being impacted:

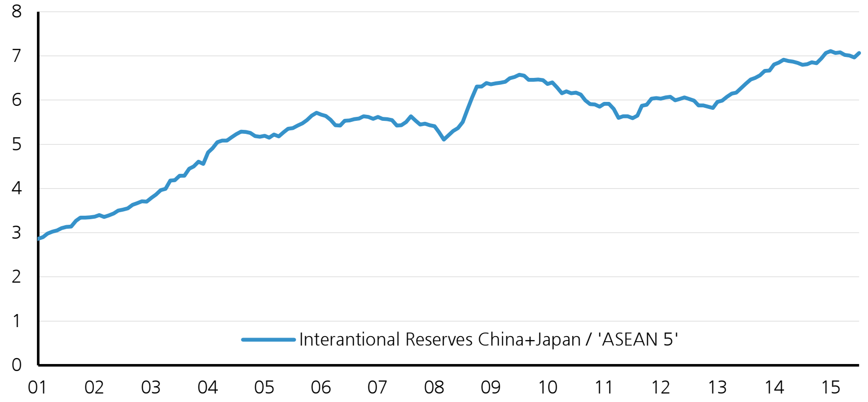
ASEAN could enjoy lower funding costs despite potential rate hike

1. Potentially lowered interest rates. The willingness to support infrastructure spending around the region with subsidised rates of interest likely means that spending may be funded at lower rates than would otherwise be available, either domestically after the credit cycle has eaten into domestic savings pools, or as US interest rates rise. Likewise, the greater influence that Japanese and Chinese banks are likely to play in south-east Asia, potentially provides lower cost alternative funding than would otherwise be the case if US interest rates start to rise.

2. Are our assumptions on macro risk premiums too high? One reason we have been concerned by the current account deficit in Indonesia over the last four years for example, is that we saw this as unsustainable and unlikely to be easily funded in a world of rising global interest rates. But what if the marginal provider of capital to these economies either has low rates, or indeed, sees the interest rate as subsidise-able for reasons beyond straight economics? In this situation, current account deficits could be more readily funded.

Likewise, as the wobbles around Tapering showed, Japan and China's offers of support to Indonesia in 2013 is a good example of liquidity support. Indonesia's current FX reserves at US$105bn are a mere fraction of China's (US$3.5 trillion) and Japan's (US$1.2 trillion) – a US$10bn line from each is less than 0.1% of each country's reserves.

Figure 5: The ratio of China and Japan's reserves compared to ASEAN 5



Source: Thomson Datastream, UBS

Risk premiums in region could be lowered, mitigating Debtopia

This should lower the risk of crisis in turn lowering the macro risk premium which might support valuations even in the face of rising US interest rates. Likewise, greater FDI, bank capital flows might allow countries to run higher current account deficits than we had previously anticipated in a world of rising US rates. This could to some extent offset our Debtopia thesis.

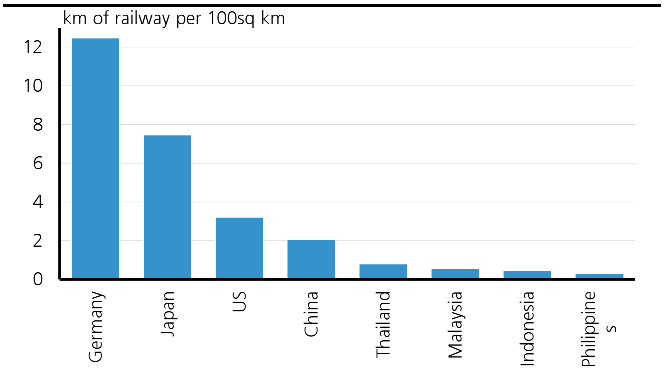
3. Enhanced growth. The sheer scale of the Japanese and Chinese economies and potential programmes coming out of China compared to many other countries in the region is substantial. Albeit this is spread over many years, and not all the benefits of the spending accrue to the 'recipient' country (much of this is driven by the need to help domestic industry), the reality is that infrastructure spending in many SE Asia countries is likely to increase. This matters. ASEAN is struggling to grow after domestic credit cycles have peaked (bank credit growth has slowed several percentage points to under 10% yoy Indonesia, Thailand, Malaysia and Singapore). Likewise, the end of the commodity cycle has lowered potential growth rates in more commodity intensive countries like Malaysia and Indonesia.

Infrastructure could boost growth in otherwise lacklustre economies

But if infrastructure spending picks up, not only is this likely to boost growth in the short-term as spending rises, but we believe it is likely to increase the productive capacity of these economies in the medium term too. For example, as Alice highlights in her note, latest estimates for Bangkok-Kunming rail project have put the cost at around $10-12bn for the Thai section alone. While ordinarily large government projects in economies can be accused of crowding out other private investment this may not be the case in Thailand, where a large current account surplus and lacklustre GDP growth suggest spare capacity **(please see full report here)**. An IMF report published in late 2014 was enthusiastic about infrastructure projects stating that, in countries where there is economic slack, debt-fuelled infrastructure can boost demand in the short-term, and in the long-term boost the productive potential of an economy. The multiplier in year one was 0.4ppt, but after four years this had risen to 1.4ppt. On the assumption shovels get in the ground from 2016 the average IMF multiplier implies the project could ultimately be worth 3.7ppts of Thailand's current level of GDP.

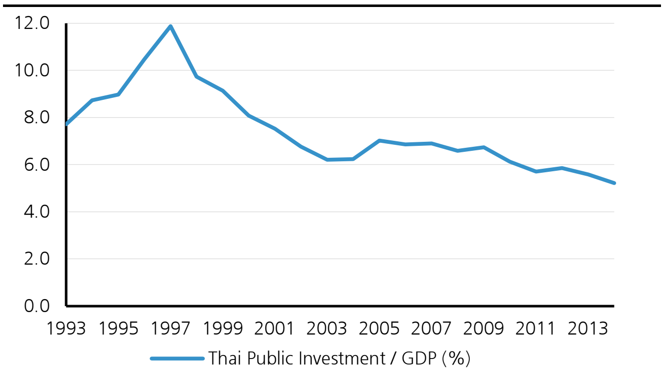
The ASEAN Economic Community (of a sorts) is due to be established by the end of 2015. Through increasing connectivity in the region, the aim is to boost trade and investment, and in turn prosperity. However, to make a reality of this vision, the ADB had previously estimated would require investment in hard infrastructure of approximately US$800bn, or approximately 30% of ASEAN's current GDP. Assuming ASEAN leaders had the ability to implement the grand vision, the questions remained how to finance this. This is why we think the patronomic theme is so timely.

Figure 6: Railway density by country



Source: The World Factbook, Central Intelligent Agency

Figure 7: Thai public investment as % of GDP



Source: NESDB, UBS

These are themes our colleagues have written about already, and we will address in subsequent notes alongside the broader macro implications in more detail. The bottom line is that we believe in the region, both China's greater role, alongside

more active Japanese involvement is likely to be a key investment theme in the coming years.

Related Research

A series of comments on the competition between the US and China for economic and political influence in Southeast Asia.

Asian Economic Comment – Friends with benefits (21 Nov '11)

Asian Economic Comment – Benefits from friends (27 Jan '12)

Asian Economic Comment – ASEAN Linkages: Friends like these (10 Sep '12)

Asian Economic Comment – ASEAN: A Friend in Need? (3 Oct '13)

Macro Keys - Asia: A political window for regional deals (22 Jan '15)

APAC Economic Perspectives – Asia: TPP may be closer than you think (4 Aug '15)

Thai Market Strategy: Economy still soft, focusing on costs. Investing in LVMC (8 Sep '15)

UBS 'ASEAN Linkages' theme

A series of longer articles on ASEAN integration

Asian Economic Perspectives – ASEAN Linkages and why they matter (24 Jun '11)

Asian Economic Perspectives – ASEAN Linkages and Liberalization (22 May '12)

Asian Economic Perspectives - ASEAN Linkages: Trans Pacific Potential (1 Nov '13)

Asian Economic Perspectives – ASEAN Linkages: Beyond 2015 (9 Oct '14)

Sino Surge

Asian Banks: Taper Tantrum 2 vs. the Sino Surge (29 Jun '15)

HK banks: Carry trade unwind Vs the 'Sino surge' (27 April '15)

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Buy	FSR is > 6% above the MRA.	45%	36%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	13%	20%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 June 2015.
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