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Macro Note

Asia: Are We Seeing Trade And Investment Diversion From US-China Trade Rift?

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- The escalation in trade tensions between US and China resulted in the first tranche of tariffs being implemented on 6 July. The second and latest tranche took effect on 24 Sep when US imposed 10% tariff on US$200bn of Chinese goods and China levied 5-10% tariff on US$60 bn worth of US goods in retaliation.

- Without a resolution to the conflicts, the US is poised to increase the tariff rate on the US$200bn of Chinese goods to 25% from current 10% in 2019 and could further impose additional tariffs on the remaining Chinese goods exports to the US next year. This will extend the impact from mainly intermediate goods in the electronics and machinery sectors currently to include more of Chinese consumer goods exports to the US.

- Given that Chinese goods will now cost more in the US and vice versa due to the additional tariffs, trade and investment diversion away from China and the US will be inevitable. This could have a larger impact on China than the US due to the sheer size of Chinese exports compared to the latter.

- The disruption to the supply chain will quicken as corporates are becoming more convinced that the trade tensions will be long-drawn and therefore warrant adjustments to their medium/long-term strategies.

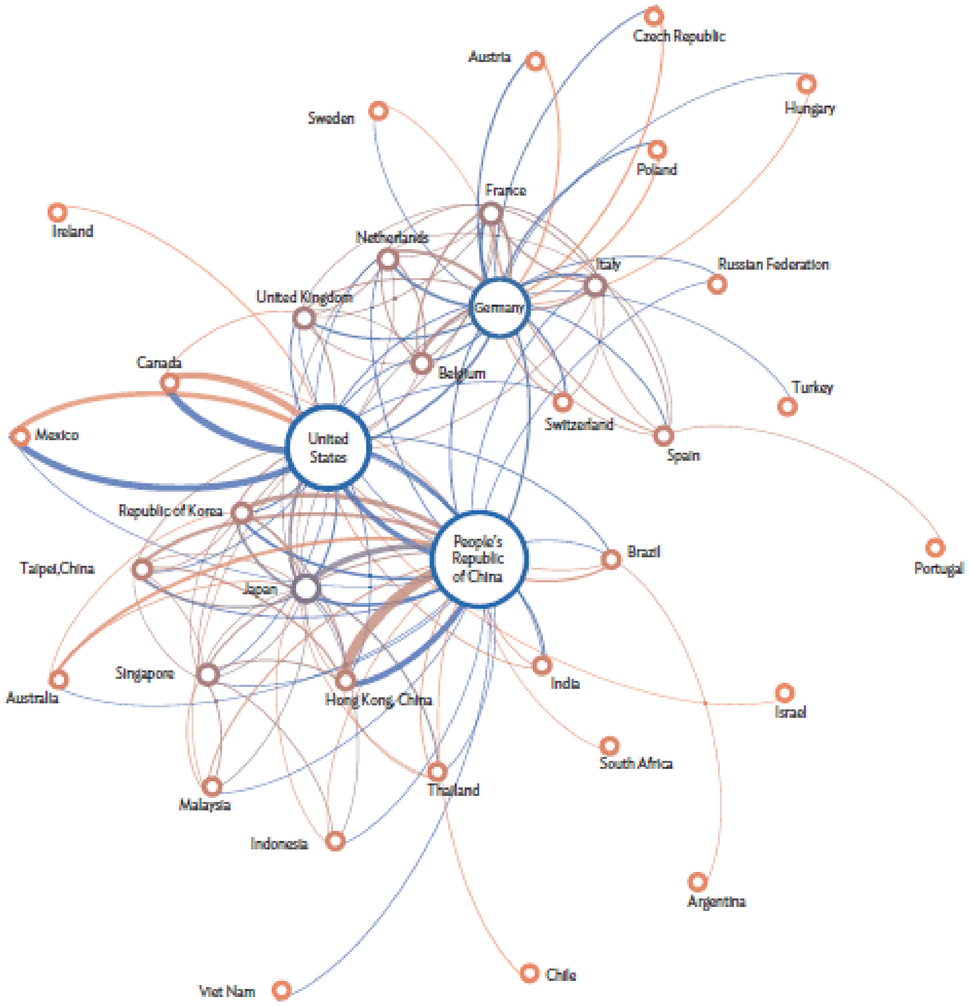
- Even before the US-China trade relations took a turn for the worse, foreign and Chinese companies alike were already looking to the ASEAN countries for investment opportunities, which include the China-led Belt & Road Initiative.

- The attractiveness of the ASEAN region was due in part to the lower wage and production costs, tax incentives and better access to the regional markets. Any further worsening in US-China trade relations will likely accelerate the flows of investment to the region.

- Based on the preliminary data on trade and investment so far, we believe that trade diversion has yet to become evident whereas there are nascent signs of investment pick-up in places such as Thailand, Taiwan and Vietnam, suggesting diversion of some manufacturing activities into these economies due to the US-China trade tensions.

The Scale Of Disruption To The Global Production Chain Will Be Large
Given China And The US Are The Main Hubs

Source: Asian Development Bank



Note: Includes the 61 economies in the Organisation for Economic Co-operation and Development–World Trade Organization Trade in Value-Added database. The figure shows only the most important bilateral flows in intermediate goods excluding oil. Line thickness indicates the size of bilateral flows, and blue lines indicate more important flows. Blue nodes are those with the highest degree of "PageRank centrality," as defined in Diakantoni et al. (2017).

Source: WB Group, IDE-JETRO, OECD, UIBE, and WTO. 2017.

No Apparent Trade Diversion Impact On The Headline Yet

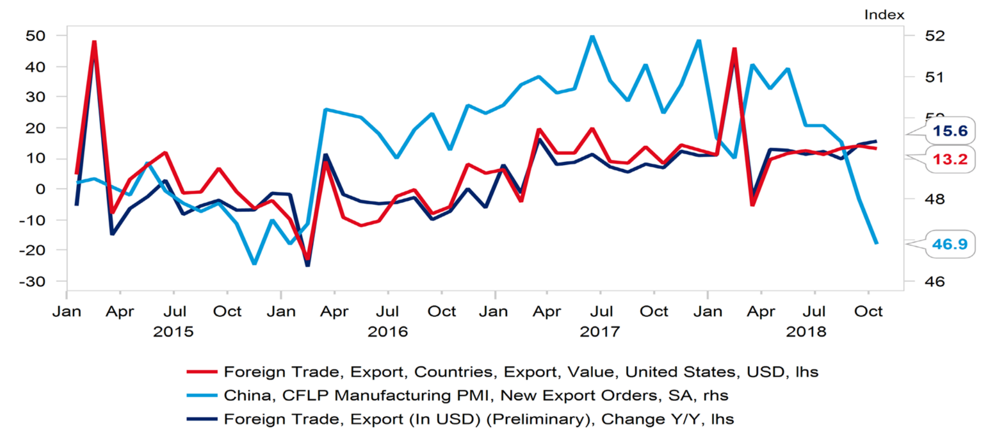
China's export growth continues to hold at double-digit pace as shown by the latest October trade numbers, helped by frontloading of orders to the US ahead of potentially more tariffs, weaker CNY and a resilient US economy. Chinese exports to US recorded the 6th consecutive month of double-digit expansion in October, indicating that trade diversion is yet to become evident on the headline but this is almost certain to take place if the US-China trade relations continue to deteriorate.

The detailed breakdown of US' imports from China showed that Chinese goods hit by the higher tariff rate of 25% such as fertilizers, road motor vehicles and metal working machinery had started to fall but these are likely to have been offset by further frontloading of Chinese exports less affected by the tariffs, ahead of potentially more punitive actions next year. On balance, this has kept China's export growth at a robust pace so far but the sharp drop in the new export orders PMI points to weakening outlook beyond the current frontloading activities. A study by Bank Negara Malaysia estimated that the potential amount of trade diversion from China could reach US$140bn.

For the rest of the Asian economies, export growth has been on a moderating trend across 2018 due in part to the high base effect from 2017 as well as a global electronics cycle slowdown. There was no discernible trend in China's or US' imports from the ASEAN region that can be attributable to the US-China trade tensions, at least on the headline. However, US' imports from Hong Kong and Taiwan have shown some weakness. Hong Kong has also reported negative impact on re-exports of goods which are of mainland origin to the US that are hit with additional tariffs.

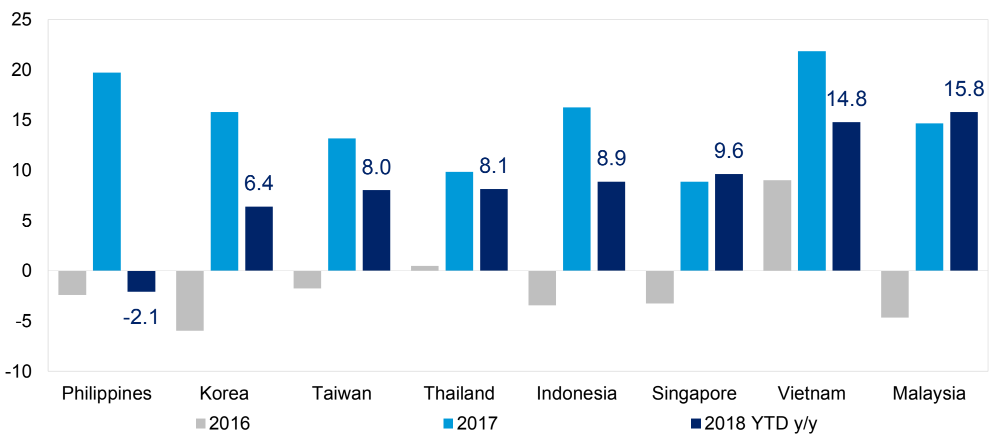
China Export Growth & Manufacturing Outlook

Source: Macrobond, UOB Global Economics & Markets Research



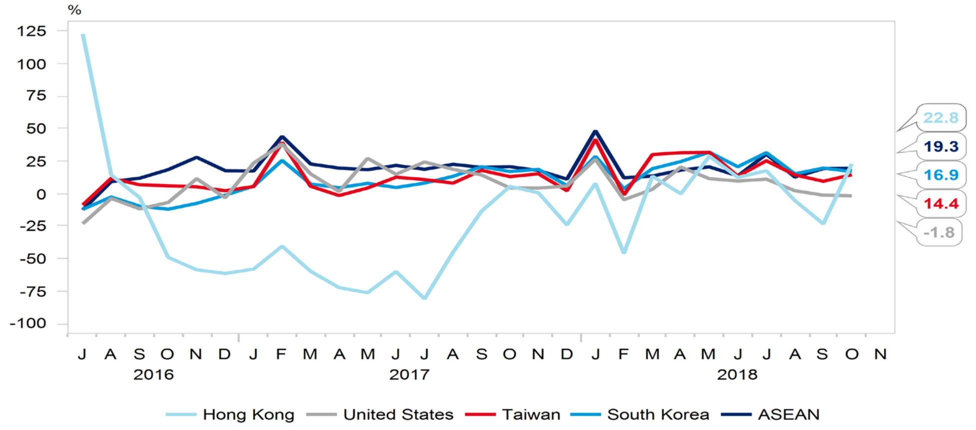
US-China Trade Tension: Export Performance (USD, y/y %)

Source: CEIC, UOB Global Economics & Markets Research



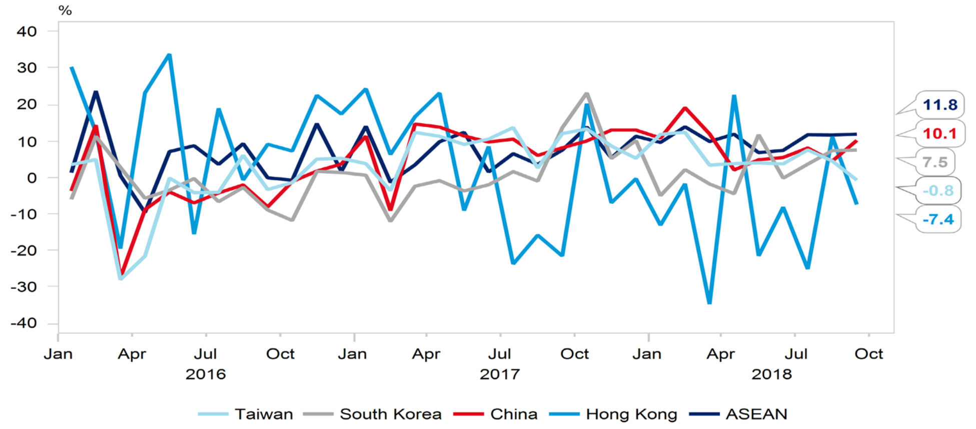
China, Foreign Trade, Import, Countries, Import, Value, USD

Source: Macrobond, UOB Global Economics & Markets Research



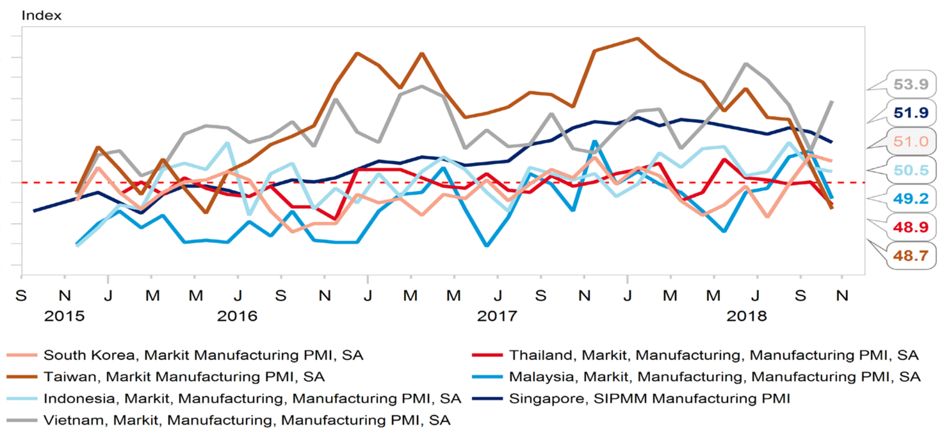
United States, Foreign Trade, Census Bureau, Countries, Import, Goods, USD

Source: Macrobond, UOB Global Economics & Markets Research



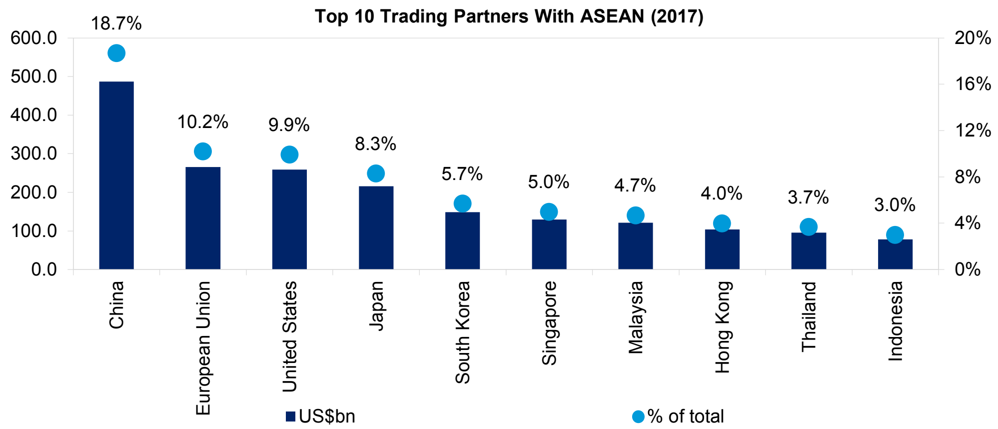
Manufacturing Outlook In Asia Largely Showing Weakening Trend

Source: Macrobond, UOB Global Economics & Markets Research



China Is Top Trading Partner With ASEAN

Source: Bloomberg, UOB Global Economics & Markets Research



ASEAN May Benefit In Some Ways

The American Chamber of Commerce in South China[1] published a recent survey report on the impact of the US-China trade tensions on businesses and investment decisions. Not surprisingly, nearly 80% of surveyed companies have experienced "serious impact or negative impact" of the combined tariffs on various business operations. Nearly half of the respondents report loss in markets to companies from other countries due to the trade war. According to the findings, the top three competitor countries are Vietnam, Germany and Japan (in order of importance). This will have impact on their investment decisions as more than 60% of the companies are delaying or canceling investments into China and a similar proportion are considering relocation of some or all manufacturing out of China. Southeast Asia is the first choice for most respondents planning relocation, suggesting some silver lining for the region. Despite the survey findings, net investment inflow was still positive in China for the Jan-Oct period with foreign direct investment up 6.5% y/y while the outward direct investment was up 3.8% y/y.

Even before the US-China trade relations took a turn for the worse, foreign and Chinese companies alike were already looking to the ASEAN countries for investment opportunities, which include the China-led Belt & Road Initiative. The attractiveness of the ASEAN region was due in part to the lower wage and production costs, tax incentives and better access to the regional markets. Any further worsening in US-China trade relations will likely accelerate the flows of investment to the region.

The manufacturing sector in ASEAN will be the biggest beneficiary, having received the largest share of China's outward direct investment in the last two years. By industry, the Economist Intelligence Unit (EIU) sees Malaysia and Vietnam as the key beneficiaries in the information and communications technology (ICT) products segment as the presence of major electronics companies in these countries will allow for easier redeployment of production and investment to these destinations. Using the same reasoning, Thailand and Malaysia will stand to gain most in the automotive segment given established export networks in these countries while Vietnam which is already an important garment production centre, will be able to scale up in the midst of the ongoing US-China tensions.

Tentative Investment Gains In Taiwan, Thailand and Vietnam

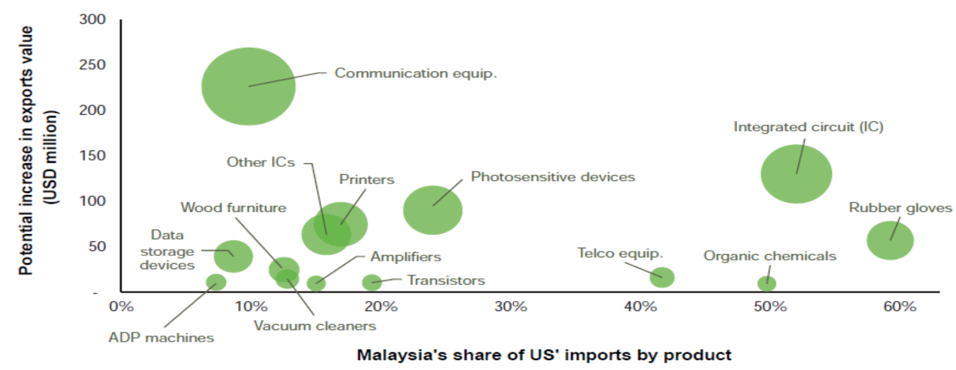
Based on the latest investment data, the YTD investments in Taiwan and Thailand have already surpassed levels in 2017 and Vietnam continues to draw the largest amount of investment compared to the other regional countries while Malaysia is also on track to register larger investment inflows compared to 2017. These markets could potentially benefit most from a shift in supply chain if US-China trade tensions drag on.

1 The survey covers 219 companies originating from the US, China and other countries and was conducted between 21 Sep and 10 Oct after the implementation of the latest round of tariffs on US$200bn of Chinese goods. More than 60% of the surveyed companies have business operations in both US and China.)

As part of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) which will come into effect on 30 Dec 2018, ASEAN countries including Malaysia, Vietnam, Singapore and Brunei have a further edge to attract these investments given the additional benefits to exporters and importers operating from these markets.

Malaysia's Exports To The US That Could Potentially Gain From Trade Substitution

Source: BNM



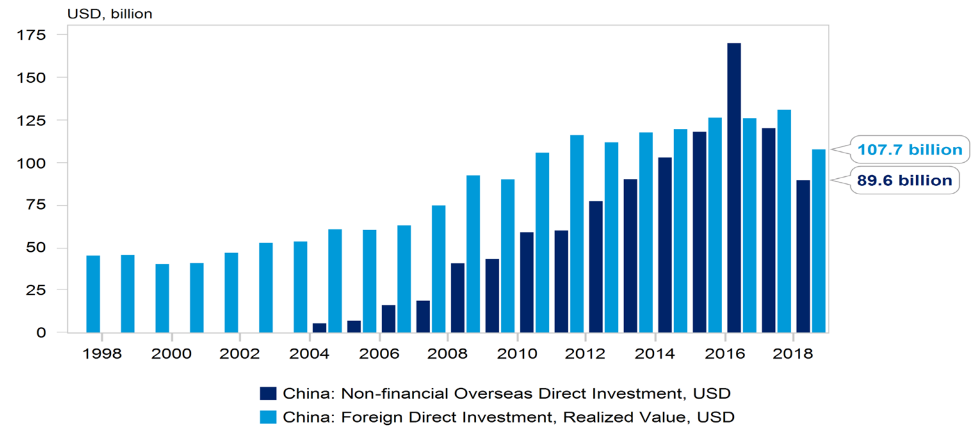
Note: Bubble size reflects potential value of gain. For clarity, chart only illustrates US import products in which at least 5% of those imports are sourced from Malaysia.

But Near-Term Outlook Still Mired By Uncertainties

Despite the silver lining of relocation of some manufacturing activities into ASEAN, near-term outlook for the manufacturing sector in the region as reflected in the PMIs are pointing to weaker prospects, perhaps with the exception of Vietnam which appears to be still holding firm. As the second largest economy and ASEAN's largest trade partner, any slowdown in China's growth will have a material impact on its demand of goods and services, thereby weighing on the growth in ASEAN. We forecast that China's GDP growth will moderate further to 6.3% of GDP in 2019 from our estimate of 6.6% this year as the impact from trade and investment slowdown will become more apparent. Countries such Indonesia which have a large domestic market may be less impacted but the negative market sentiments affecting the currency may cause further disruption to the external sectors.

China: Foreign Direct Investment and Outward Direct Investment

Source: Macrobond, UOB Global Economics & Markets Research

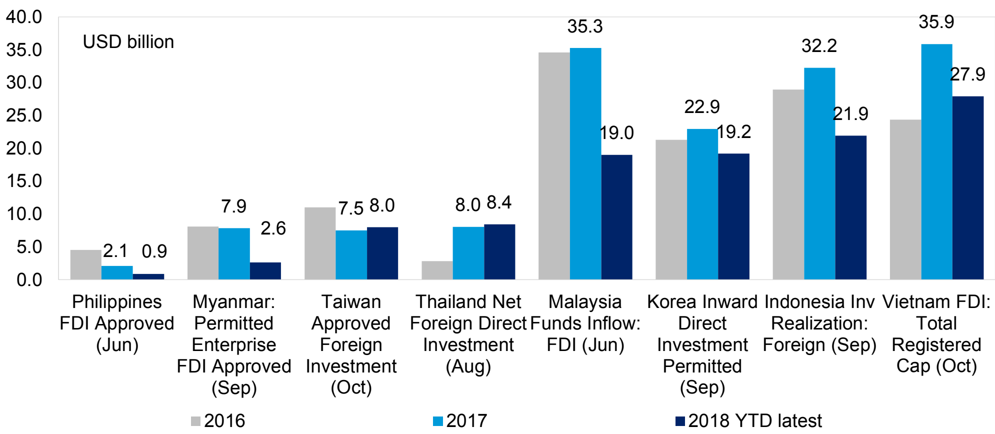


Wage Costs In ASEAN Are Mostly Lower Than In China

Source: CEIC, ILO, UOB Global Economics & Markets Research

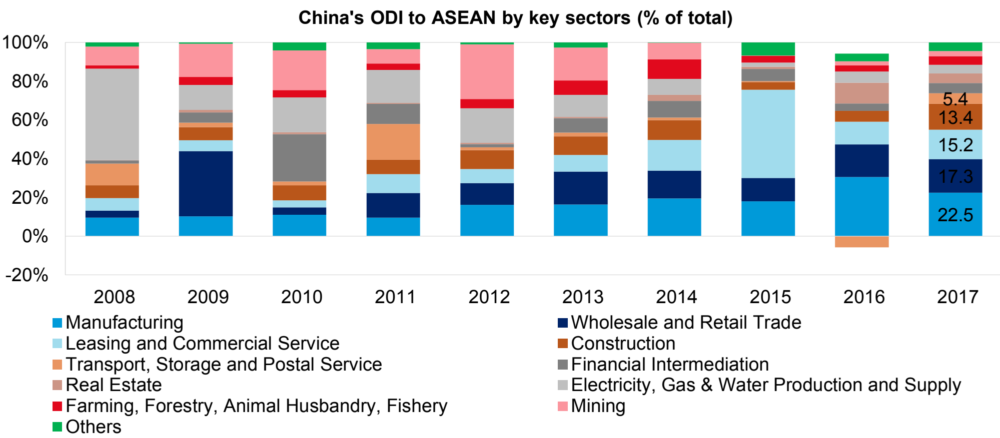
US-China Trade Tension: Signs of Investment Diversion?

Source: CEIC, UOB Global Economics & Markets Research



Manufacturing Receives Largest Share Of China's Investment In ASEAN

Source: CEIC, UOB Global Economics & Markets Research



ASEAN: Major Trade And Investment Opportunities	
Vietnam	Relocation of supply chain activities to Vietnam is likely to be most pronounced in more basic industries such as wood product furniture, textile and apparels. For more sophisticated industries with more complex supply chains such as mobile phones, automotive, laptops and electronics, we may see the shift of activities with lower value-added in the realms of production and assembly, as an initial response in supply-chain adjustment. 1. Intel, Foxconn, LG, and Samsung have recently relocated some parts of their manufacturing to Vietnam. 2. Goertek, the Chinese company assembling Apple's AirPods, has rerouted all production of the earbuds to Vietnam.
Thailand	There is potential to increase exports of computer parts to the US and farm products to China such as cassava chips, soybean, seafood, processed food and frozen food. Potential relocation of investment to Thailand are in industries producing aviation parts, automobile and parts, computers and parts, electronics, energy equipment, and agricultural machinery. 1. Harley Davidson shifted part of its processes to Thailand. 2. Delta Electronics, which supplies power components to Apple Inc., offered $2.1 billion in July to purchase a Thai affiliate to expand production. 3. Merry Electronics making headphones for firms like Bose Corp. intends to move some of its production to Thailand from southern China.
Indonesia	Indonesia has absolute advantage in resource-based sectors and her commodity exports to China are estimated to arrive as final consumption products vis-à-vis a raw or intermediate products for re-exporting. It is also expected to see some mild benefits in ICT and automotive production relocation as a result of the US-China trade tensions. Investments are also rising in the areas of telecommunications and provision of consumer products, notably dairy-based consumption products. The top 5 sector investments based on the latest FDI reports suggested the areas of energy provision (electricity, gas, and water supply), transportation and storage as well as telecommunication, construction-related (real estate, industrial, an office buildings), mining, and non-machinery metal industries continue to be the areas of great interest. These areas are somewhat less affected by the direct effect of the trade tensions, although indirectly it has been affected through the slowing down of the FDI's momentum that is seen notably in Q3 this year.
Malaysia	Based on the central bank's study, the products that Malaysia would likely gain from trade substitution opportunities are mostly in the E&E industry, such as electrical machines, electronic integrated circuits and semiconductors for solar panels cells. 1. Large entry of Chinese semiconductor assembly and test player into Malaysia's semiconductor firm Unisem. 2. MNCs' enquiries to local outsourced semiconductor and test companies (OSAT) have risen. These include enquiries for the possibility for OSAT to go downstream in electronics manufacturing and transfer of MNCs' matured products in China to Malaysia, which the local companies are not keen due to the labour intensiveness and lower margins. 3. A number of MNCs with existing operations in Penang are in the midst of expanding or planning for expansion. Higher demand for machines from MNCs operating in Malaysia.
Myanmar	There is increasing interest to establish manufacturing and production facilities in Thilawa Special Economic Zone (SEZ) among the firms. Myanmar signed a memorandum of understanding (MoU) with China in September 2018 agreeing to establish the China-Myanmar Economic Corridor (CMEC), part of the Belt and Road Initiative. Under the MoU, the governments agree to collaborate in several industries such as transport, basic infrastructure, construction, manufacturing, agriculture and telecommunications. In November 2018, the Myanmar government and China's state-owned CITIC Group signed the framework agreement for the proposed US$1.3 billion deep-sea port in Kyaukphyu. Myanmar is also in the midst of finalizing an agreement to export cattle to meet increasing Chinese demand.
Philippines	Economic Planning Secretary Ernesto Pernia said that the US-China trade war should benefit the Philippine economy, helping increase exports by 5% as the country becomes an alternative source of products and even a site for supply chains. He added that there are already signs electronics and computer components, previously sourced from China, are now going to the Philippines. 1. Ayala Corp is in talks to provide land to a Chinese company planning to build one of the world's biggest tile factories in the Philippines. 2. Chinese steel company Panhua Group will build a 305-hectare integrated steel manufacturing plant at an industrial estate in Misamis Oriental Special Economic Zone, with an investment of US$3.5bn. 3. China Gezhouba to invest initial US$2bn in New Clark City to develop 500-hectare mixed-used industrial park in Clark, north of the capital, which is expected to attract electronics manufacturing companies, technology firms and light industries. 4. New Kinpo Group, a Taiwanese contract electronics maker, looks to build new facilities in the Philippines.

Source: Bloomberg, Newswires, UOB Global Economics & Markets Research

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