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Recession  
Watch  
Slowing, Not  
Stopping

**Keppel** Capital  
**watch**

## Recession Watch

Slowing, Not  
Stopping

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## Executive Summary

The global economy enjoyed nearly two years of synchronised growth since 2017, but the strong momentum appears to have run its course. Growth forecasts for the next two years have been successively downgraded and some market watchers are warning of a potential recession over the horizon. Despite the slowdown, a global recession does not appear on the cards.

In the US, Donald Trump's trade and fiscal policies have disrupted the business cycle, potentially leading to a slowdown by end-2019 as the fiscal impulse fades and GDP reverts to trend growth. The US Federal Reserve (Fed) has adopted a more dovish tone signalling that rates will likely be kept on hold for the rest of the year. Should liquidity conditions tighten, the rapid growth of leveraged loans in recent years could trigger credit events, but a recession in the US is not our base case scenario.

US-Sino trade frictions have affected business confidence in China, but the economic slowdown can be more directly attributable to factors such as the deleveraging campaign and economic rebalancing. The trade row may slow China's "Made in China 2025" initiative but will not derail its industrial upgrading ambitions. The Chinese government will continue to rebalance its economy by supporting the private sector, encouraging more domestic consumption and opening up more of its markets to foreign investors.

Growth in the rest of Asia Pacific (APAC) is expected to trend lower in sync with the major economies and exacerbated by the ongoing electronics down cycle, but monetary conditions are expected to remain accommodative to neutral. Over the longer term, drivers such as urbanisation and increased infrastructure investments continue to underpin growth in emerging Asia. Europe stands out as the weakest link in the global economy, with its economic outlook further impinged by political risks amid an election cycle.

While we do not expect an impending recession barring a black swan event, risks persist in the global economy. Periods of financial volatility could result in market dislocations, potentially presenting investment opportunities. We remain selectively positive on real estate markets in APAC. Emphasis on submarket fundamentals is critical by focusing on the secular trends of urbanisation, a growing middle class and improved connectivity through better infrastructure. With the appropriate risk management premised on income stability and sustainable rental growth, investors should look to maintain or even increase their exposures to APAC real estate.

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## Introduction

### Déjà vu

After two years of synchronized global growth since 2017, projections of global growth have been revised downwards by organisations such as the International Monetary Fund (IMF) and World Bank on fears of mounting downside risks. Financial markets are once again dominated by a growing narrative that an impending economic slowdown could spiral into a recession. The economic downgrades hark back to a similar situation in 2016, which subsequently turned out to be a red herring as not only was a recession averted, but global growth strengthened.

We last flagged out several “grey rhinos<sup>1</sup>” in our 2016 report: [“Recession Risks: Uncertainty the New Norm”](#). In this paper, we dig deeper into potential economic risks over the horizon and how these may impact real estate investment strategies. While black swan events by definition cannot be predicted, a better understanding of grey rhinos will help investors make better-informed investment decisions.

## US: Trumpian tantrums

### New world “dis”-order

Donald Trump is in his third year in the Oval Office in 2019 and has made his presence felt all over the world. While the US economy has been performing above potential in the past two years, that growth momentum is not sustainable. We highlight some of the potential risks in the US economy which may portend a sharper-than-expected economic slowdown over the next 24 months or so, but our base case is that a recession is not on the cards.

### 1) Rocking the trade boat

One of Donald Trump’s presidential campaign promises was to redefine US trade relations from a multilateral system to a bilateral one. He has taken aim at countries that run large bilateral trade surpluses with the US, with China being his main target. After placing tariffs on USD50 billion worth of imported Chinese goods, an escalation of tariffs on another USD200 billion which were supposed to come into effect from 2 March 2019 have been put on hold amid ongoing negotiations as both sides try to reach an agreement. However, Trump has also suggested that existing tariffs will not be removed even if a deal is reached to ensure China’s compliance.

The Chinese government appeared willing to import more US goods such as soybeans to narrow the bilateral trade surplus, accelerate the opening-up of more market segments and strengthen its intellectual property (IP) protection laws, including the prevention of forced technology transfers. The US has reportedly demanded that the Chinese authorities agree to stop currency manipulation, although no specifics were given. While the Chinese are likely to agree to these conditions in principle, how and if they can be enforced remains to be seen.

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<sup>1</sup> A highly probable, high impact yet neglected threat. From the book “The Gray Rhino” by Michele Wucker.

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These trade jibes have already begun to take a toll on the global economy. Asian manufacturing PMIs were mostly tracking downwards towards the end of 2018, as anxieties over the potential impact of trade tariffs spread to regional countries which are part of the Asian supply chain. Manufacturing PMIs in China, Taiwan and South Korea were in contractionary territory as of December 2018, dimming their outlooks for 2019 and 2020 should the trade standoff remain protracted. Some improvements were observed in the March 2019 readings, but it is too early to conclude that a recovery is underway.

The US will not be completely unscathed in the event of an all-out trade war since many of the tariffed products are not easily substituted. US importers like Walmart and Home Depot will likely have to bear the costs initially and depending on the price elasticity of demand for individual items, some of the price increase could be passed on to American consumers. If so, consumers end up paying more for the same item; if not, the profit margins of the importers will be squeezed. Luggage retailer Samsonite and appliance maker Whirlpool are among a number of companies which have already raised selling prices in the US to offset higher import costs.

### 2) The Fed conundrum

The Federal Reserve (Fed) has a dual mandate of pursuing maximum employment and price stability within the US economy. The Fed generally guides for an inflation target of 2% (usually measured using core personal consumption expenditure [PCE] inflation), while its current estimate for long-run normal rate of unemployment stands at 4.3%.

Since December 2015, the Fed has announced a total of eight rate hikes, taking the Fed Funds target rate to 2.25-2.5% as of end-2018, pointing to the robust economy and tight labour market as justifications for normalizing rates, even though the core PCE inflation rate remained below the Fed's 2% target. As of the Federal Open Market Committee (FOMC) meeting in December 2018, the Fed had projected two rate hikes in 2019.

In January 2019, Fed policymakers took a dovish turn and suggested patience over future rate hikes amid crosscurrents from financial and economic developments. By the FOMC meeting in March 2019, the Fed became even more dovish than expected, indicating that rates are likely to remain on hold for the rest of the year within what the FOMC judged to be the neutral range which is neither expansionary nor contractionary. Nonetheless, the Fed lowered its GDP growth projections for 2019 and 2020 to 2.1% (from 2.3%) and 1.9% (from 2.0%) respectively. Fed Chair Jerome Powell further stated that while the US economic outlook remains fundamentally strong, weaker global growth could pose as headwinds. Following the latest statement and the subsequent fall in global bond yields, the probability of a rate cut by end-2019 as implied by Fed Funds futures increased to ~50% as of 11 April from 25.8% just before the March FOMC meeting.

### 3) Corporate debt woes resurface

Overall corporate debt in the US has been growing steadily. According to the Bank for International Settlements (BIS), total credit to non-financial corporations (NFCs) in the US amounted to 74.4% of GDP as of 2Q2018, higher than the Global Financial Crisis-peak US credit-to-GDP of 72.5% in

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4Q2008, although the debt service ratio (DSR) for US NFCs stood at 41.3% as of 2Q2018, below the GFC-peak of 44.3%. The debt burden of corporates is manageable for now and expected to remain so if interest rates are on hold or even fall. However, any future increase in interest rates without a corresponding increase in corporate earnings will lead to higher DSRs and potentially to financial distress.

A particular segment of loans called “leveraged loans” has come under greater scrutiny by a chorus of regulators and economists including the Fed, IMF and BIS. The outstanding stock of leveraged loans to US NFCs stood at USD1 trillion as of 2Q2018, or about 7% of total outstanding business credit. While not the most significant type of credit outstanding, the leveraged loan market is the fastest-growing credit segment with growth of 15.1% p.a. since 2000, compared to average growth rates of 5.7% for bonds and commercial paper and 3.1% for bank lending.

Besides the high growth rates of leveraged loans, a key concern is the deterioration of underwriting standards as reflected by the share of covenant-light issuances rising to a record-high of 78.6% as at August 2018, drawing parallels with the subprime crisis. While interest rates are expected to remain low for some time, defaults could rise if financial conditions tighten in the future and recovery rates could deteriorate, which could trigger significant liquidity events including spillovers to other markets.

#### 4) Pump-priming in an economic recovery

Trump’s Tax Cuts and Jobs Act (TCJA) was signed into law in December 2017, with the Trump administration touting that the USD1.5 trillion tax cut will pay for itself and boost annual GDP growth to ~4%. The timing of such fiscal stimulus was debated, given that the US economy was already showing signs of a healthy recovery.

The touted benefits of TCJA have not been fully apparent. Business confidence lifted and the unemployment rate improved to marginally below 4%. Full-year GDP growth in 2018 was 2.9%, the fastest rate since 2015, boosted by a pick-up in government spending and goods exports. However, there has been little evidence that businesses are meaningfully reinvesting their tax savings and repatriated cash. Instead, corporations on the S&P500 intensified their share buybacks, purchasing an estimated USD1 trillion worth of shares in 2018, nearly the combined value of share buybacks in 2016 and 2017. This suggests that much of the benefits of the tax reforms went to shareholders rather than spur capex, dimming the prospects for a more sustainable boost to the economy via productivity improvements over the long run.

Many economists have likened the TCJA to a “sugar rush”, as the fiscal impulse is expected to fade by 2H2019. Any attempt at further fiscal stimulus is likely to be impeded by a divided Congress, especially when the national debt continues to pile up to fund the Federal budget deficits. Consequently, US GDP growth is expected to retard in 2019 and more noticeably in 2020 as growth converges back towards the potential growth rate of 1.9% p.a.<sup>2</sup>.

<sup>2</sup> Based on median forecast of longer run GDP growth from Mar 2019 FOMC meeting

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### 5) Yield curve inversion – a US recession looms?

An inverted yield curve (i.e. long-term bond yields are lower than short-term bond yields) has long been a bellwether for an impending recession with a 12-18-months' lead time, having preceded every US recession in the last 60 years<sup>3</sup>. The yield spread between 10-year US Treasury (UST) bonds and 3-month US Treasury Bills had been in a general downtrend since December 2016, suggesting a flattening yield curve.

In March 2019, 10-year UST yields dived lower after the Fed's extra-dovish statement on slowdown fears, temporarily inverting the yield curve in the last week of March 2019. Other benchmark yields on German Bunds, Japan Government Bonds and UK gilts also fell in tandem as markets priced in the rising possibility of a global slowdown. The bearish bond trades were likely overdone as yields subsequently edged back up, but even if the current fundamentals of the US economy appear healthy, the US will not be immune to the afflictions of the global economy.

Using the US yield curve as a basis, the New York Fed estimated in March 2019 that the probability of a recession within the subsequent 12 months had increased to 27.1%, up from 14.5% in September 2018. While this breached the 25% threshold which had preceded previous recessions, it may be premature to be alarmed; foreseeable risks remain under control and current long-term bond yields may be more depressed than usual given the bloated balance sheets of major central banks. We think a clearer signal would be if the US yield curve inversion recurs and persists for months, therefore reflecting a more somber view that a steeper downturn could be on the cards.

## China: Down but not out

### Challenges aplenty, but growth potential still exists

China has been grappling with the delicate act of managing an economic slowdown through deleveraging, reducing excess capacity, cost reduction and more efficient allocation of resources since Xi Jinping took over as president in 2013. At the same time, structural reforms to transition into a more sustainable model of economic development through technological upgrading, services sector expansion and stronger domestic consumption takes time.

The Chinese government has done well to avert a hard-landing thus far and is targeting GDP growth of 6.0-6.5% in 2019. Growth needs to average 6.2% p.a. over the next two years to achieve Xi Jinping's national goal of doubling China's 2010 GDP in 2020. This should be achievable under normal circumstances, but China's balancing act has become more challenging after landing in the crosshairs of the Trump administration.

### 1) Trading blows on merchandise trade

China has been a key target of Trump's "America First" rhetoric since his campaign trail in 2016. Originally threatening to label China as a currency manipulator, the Trump administration has called for a reduction in China's large bilateral trade surplus with the US which it claims is unfair.

<sup>3</sup> "Did the Yield Curve Flip? Will the Economy Dip?", Federal Reserve Bank of San Francisco, Feb 2019

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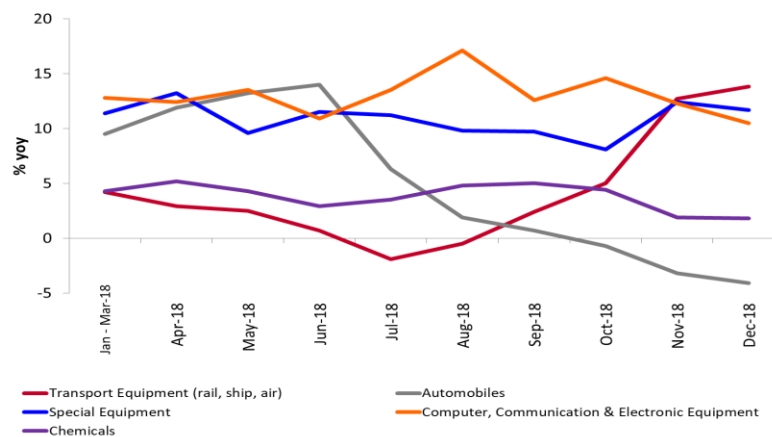
Trump's early objectives were two-fold, namely for China to step up its import of US products and for US importers and consumers to rely less on China exports and buy domestically instead. As mentioned earlier, trade talks are still ongoing as the finer details of a trade deal are being hammered out. Nonetheless, if talks break down and tensions re-escalate, the worst-case scenario could see tariffs slapped on all USD500 billion of Chinese exports into the US, which account for ~4% of China's GDP.

As long as threats of tariffs persist, business confidence will be negatively impacted and planned capex in China may be deferred or aborted. However, we do not expect a widespread relocation of production facilities out of China. According to a survey by Morgan Stanley, companies which are reviewing their China supply chains plan to move only ~8% of their existing production capacities out of China, given the difficulties in moving the supply chain in the short term. Moving supply chains can also be costly and the timeliness depends on the level of spare capacity available in the new base of production, including the necessarily skilled labour and local suppliers.

The top three destinations or regions that are likely to benefit from such relocations are ASEAN, Taiwan and Mexico. Such moves are extensions of the "China Plus One" strategy to diversify production bases which corporates have already been adopting for nearly a decade. We believe that the relocation of the supply chains will not materially impact China's economy as the bulk of the production lines that will or have been diverted are for lower-end manufacturing, whereas China is progressing into higher-value manufacturing and services.

Amid the trade row, business confidence in China has deteriorated, with the official manufacturing PMI declining since September 2018. The manufacturing PMI rebounded into expansionary range in the latest reading in March 2019, possibly an indication that stimulus measures may be coming into effect. A breakdown of industrial output by segments reveals that the threat of tariffs has yet to translate to lower production for all industries. The biggest drag has come from automobile production (Figure 1) after car sales collapsed as tax breaks offered to consumers in 2016 lapsed in 2018.

**Figure 1: China's Industrial Production Growth by Key Segments**



Source: National Bureau of Statistics

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### 2) Industrial upgrading hits a speedbump but not derailed

A deeper undercurrent of the US-Sino trade dispute relates to advanced technology and could derail China's "Made in China 2025" initiative to develop expertise in high-tech areas such as Artificial Intelligence (AI), 5G mobile technology and the Internet of Things (IoT). Some commentators have described the trade standoff as an attempt by the US to contain the rise of China and its ability to attain supremacy in high-tech fields.

Chinese telecommunications companies like ZTE and Huawei are facing sanctions on various fronts, including being labelled as national security risks. Both companies are leaders in the race to commercialise 5G technology, which will be the backbone for critical 21<sup>st</sup> century technologies like cloud computing, AI and IoT. Critics have suggested that the actions taken against Huawei are partly commercially-motivated to protect and favour lagging US companies<sup>4</sup> in the 5G race and prevent a situation where global 5G standards are owned by Chinese companies.

Additionally, the Office of the United States Trade Representative (USTR) asserted that the Chinese government directed agents to obtain commercial secrets from US companies, predominantly in the aerospace and high-tech sectors in support of China's industrial policy. China has continuously denied and objected to these allegations, but any trade deal is likely to require China to enact and enforce stronger laws on IP protection, including mechanisms for regular audit by the US. Chinese lawmakers have drafted revisions to its patent law in December 2018 to strengthen IP protection by raising fines for violations. Whether such a revision when passed into law will be deemed sufficient by the US to avoid regular inspection remains to be seen.

The Chinese government has already dialed down public mentions of the "Made in China 2025" initiative, but it will not give up its industrial upgrading ambitions. Chinese tech companies will continue to make full use of domestic testbeds to develop and refine new technologies. For instance, the recently-announced plans for the Guangdong-Hong Kong-Macao Greater Bay Area (GBA) aims to harness the combined strengths of China's southern cities, including Guangzhou, Shenzhen, Hong Kong and Macao, to create a city cluster capable of rivalling major bay area economies such as the San Francisco Bay Area, New York Metropolitan Area and Tokyo Bay Area.

Key areas of focus for the GBA include:

- 1) Developing an international technology and innovation hub covering technology R&D, infrastructure and finance sectors;
- 2) Accelerating infrastructure to improve the flow of talent, goods and information covering transportation, telecommunications and energy sectors;
- 3) Building a globally competitive modern industrial system covering advanced manufacturing, modern financial and professional services; and

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<sup>4</sup> "The War on Huawei", by Jeffrey Sachs on Project Syndicate



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- 4) Developing a quality living environment based on creating an education and talent hub and promoting healthcare, entertainment, leisure and cultural developments.

### 3) Debt problems persist but mostly contained

China's leverage problem has been a matter of concern for market watchers and Chinese leaders. Former People's Bank of China (PBoC) Governor, Zhou Xiaochuan, even warned that a build-up of excesses, e.g. debt and asset prices, could lead to a "Minsky Moment" - a situation when debt levels reach breaking-point and asset prices across the board start plunging.

The deleveraging efforts have produced mixed results thus far. The much-touted debt-to-equity swap programme remains limited in implementation despite the authorities' efforts to promote it. On the other hand, tighter regulation in the shadow banking sector has led to the closure of over 1,000 Peer-to-Peer (P2P) lending companies in 2017-2018 and the transfer of new credit supply from core shadow banking comprising trust loans, entrusted loans and undiscounted bankers' acceptances back to formal bank lending.

Much of China's leverage lies with non-financial corporate debt, which stood at 152.9% of China's GDP as at 3Q2018. Approximately 62%<sup>5</sup> of that is held by state-owned enterprises (SOEs), implying that non-financial SOEs' debt-to-GDP ratio is over 90%. Part of this belongs to zombie SOEs - companies which do not generate enough revenue to repay its debts but are kept alive by government subsidies or financing by state-owned banks. Cleaning up zombie companies is a daunting task, as it also entails redeployment of their labour force to other sectors of the economy. Meanwhile, private small and medium-sized enterprises (SMEs) are often starved of financing and face higher costs of borrowing.

China's high corporate indebtedness may be a concern, but unlikely to pose a systemic risk since it is largely domestically-funded by the four major state banks which have nearly half of the market share of loans. The official proportion of non-performing loans within the Chinese banking system has remained relatively stable at 1.8% as at 4Q2018. Together with special-mention loans, problematic debt makes up a manageable 5.0% of total loans as at 4Q2018, improving from 5.6% as at 4Q2016.

Chinese onshore bond default rates remain low by international standards, but more instances of bond defaults can be expected as companies facing financial difficulties go into distress amid the slowing economy. Targeted easing by the authorities via tools like Reserve Requirement Ratio (RRR) cuts and the Medium-term Lending Facility (MLF) will help to ensure liquidity and facilitate refinancing, but the weakest corporates are still likely to default.

There are indications that the deleveraging efforts may be taking a back seat as the government turns back to debt to finance more infrastructure investments to support growth amid the slowdown. However, the government is unlikely to resort to a drastic relaxation of credit conditions

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<sup>5</sup> National Institution for Finance & Development estimate, as at end-2017

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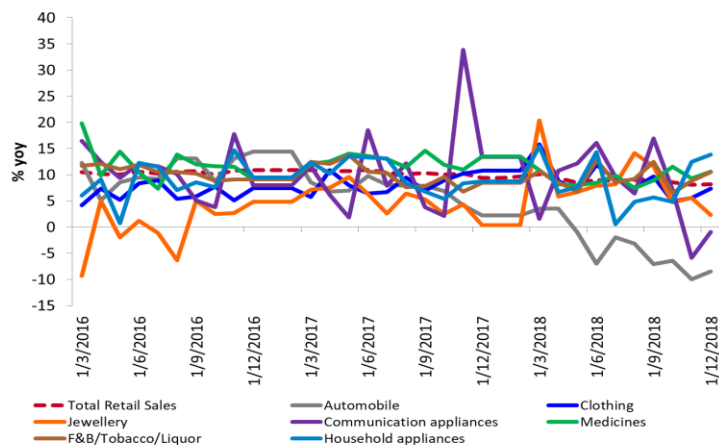
and will instead look towards wider policies and measures to support the private sector and domestic consumption.

### 4) Will consumers come to the fore?

Domestic private consumption makes up ~40% of China's GDP, lagging fixed asset investments (44%). To mitigate the impact of the US-Sino trade war and a slowdown in fixed asset investments from the deleveraging drive, the Chinese government is looking to domestic consumers to pick up the slack.

Labour market conditions remain benign. China's official urban unemployment rate held steady in 2018, ending at 4.9% in December 2018. Nationwide per capita disposable income rose by 8.7% yoy on nominal terms in 2018, lending support to the 9.0% growth in total retail sales growth. While the latter's growth was credible, it has come off from just over 10% p.a. in 2016 and 2017. Drilling down sales performance by segments, much of the slowdown can be attributed to falling car sales since mid-2018, as previously mentioned (Figure 2).

**Figure 2: China's Retail Sales Growth by Selected Categories**



Source: Bloomberg

The other consumer segments are more mixed. In January 2019, tech giant Apple downgraded its iPhone sales guidance in China for 1Q2019, attributing it to the slowing economy and trade tensions. However, local smartphone makers like Huawei and Oppo are quickly gaining market share with more innovative products at more affordable prices<sup>6</sup>. Other retailers like Starbucks, Adidas and Nike maintain sanguine views of the Chinese market. More notably at the luxury end, groups like L'Oreal and LVMH reported accelerating sales within China in 2018 and remain confident for 2019.

The Chinese government has rolled out a few measures to boost consumption in 2019. Besides introducing subsidies to reinvigorate the auto industry, the Chinese government also announced special additional deductions for individual income taxes, effective 1 January 2019. While the direct impact of individual income tax cuts on disposable income is marginal, it is expected to lift consumer sentiment.

<sup>6</sup> <https://www.cnbc.com/2019/02/11/iphone-shipments-in-china-fall-19point9-percent-idx.html>

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### 5) Currency stability

As trade tensions escalated in 2018, the CNY depreciated nearly 10% against the USD between April and October and was close to breaching the USD1=CNY7 level. From the Americans' perspective, they are wary that China may use the CNY as a mercantilist tool to offset the impact of tariffs and artificially make their own exports more attractive. This explains why a currency manipulation agreement has been included in the trade talks.

On the contrary, China has already moved to a more market-oriented managed-float regime which is trade-weighted against a basket of currencies other than just the USD. It is in the Chinese government's interest to ensure stability in the CNY, especially after witnessing the aftermath of its snap 2% devaluation against the USD in August 2015. A quick loss of confidence in the CNY could spark a downward spiral as investors and residents pull capital out of the country despite its capital controls. Not only could this trigger a collapse in asset prices, it will also derail the PBoC's efforts to make the CNY a global currency in the long run.

The outlook for the CNY in 2019 will largely hinge on the outcome of the US-Sino trade talks. If the talks are successful, the CNY is likely to remain fairly stable against the USD, especially with the Fed's current dovishness. However, if talks break down, the CNY may again face depreciation pressures as traders grapple with the impact it may have on the Chinese economy.

We think the PBoC will tolerate a controlled and moderate devaluation of the CNY in the near term, subject to the conditions allowed under the proposed trade agreement. This will be consistent with the slowdown in GDP growth and the targeted easing policies such as RRR cuts to lower the cost of borrowing. In addition, China's current account surplus has been already been on the decline, largely because of a growing services trade deficit.

The PBoC has plans to attract more capital inflows over the medium to long term by allowing greater foreign participation in its bond and equity markets and attract more foreign direct investments (FDI) as China opens up more sectors. The trade conflict with the US could accelerate China's market reforms and opening-up, which will bring new growth opportunities and thus lend support to the CNY and increase its attraction as a global currency.

## Rest of APAC: Secular trends remain supportive

### Growth to outpace rest of the world despite synchronised slowdown

US-Sino trade tensions may disrupt regional trade in the short-term due to the interconnectedness of Asian supply chain, but in the longer run, some economies can benefit from potential trade and manufacturing diversions. The Fed's pause bodes well for monetary conditions in APAC, which are expected to remain accommodative to neutral. However, the ability of the governments to support growth through fiscal expansion is more mixed. The IMF expects the APAC region's GDP to grow at 5.1% in 2019 and 5.2% in 2020, slightly lower than the 5.3% in 2018 but still significantly above the global average of 3.3% and 3.6% for 2019 and 2020 respectively.

### 1) Opportunities abound for emerging APAC

Emerging markets like ASEAN-5 (Indonesia, Malaysia, Philippines, Thailand and Vietnam) will continue to underpin APAC economic growth in the coming

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years. This will be on the back of more FDIs, rapid urbanisation with around 500 million more people moving into cities by 2030<sup>7</sup>, and a growing middle-class of 3.5 billion people by 2030<sup>8</sup> supporting domestic consumption. These trends fuel the need for increased infrastructure investments across the region; the Asian Development Bank estimates that developing Asia requires USD1.7 trillion of infrastructure investments every year till 2030, the equivalent of South Korea's entire annual GDP output.

Vietnam is expected to be a major beneficiary from the relocation of low-cost labour-intensive production plants from China, a trend that began even before the escalation in trade tensions. Besides the textile and garment industries, Vietnam is also growing in relevance as a production base for electronics. Having ratified the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in November 2018, Vietnam exporters could gain from greater regional trade. Vietnam's GDP growth came in at 7.1% in 2018, the fastest rate in the past ten years. With FDI inflows expected to remain strong, the government expects GDP growth in 2019 at 6.6%-6.8%.

Indonesia is an attractive market for many multinational companies, given its large domestic market of 260 million people and rising middle-class. Some companies such as Pegatron, Apple's second largest contract manufacturer, have also identified Indonesia as an alternative production base. While logistics infrastructure in Indonesia has improved in recent years, it remains relatively underdeveloped. We expect continued improvement in the medium to long term on the back of increased government spending on infrastructure, which will improve Indonesia's attractiveness as an alternative destination for supply chain relocations. GDP growth in 2018 came in at 5.2%, supported by strong household consumption and steady investment spending. The IMF expects Indonesia's economic growth to remain resilient at 5.2% p.a. in 2019 and 2020.

### 2) Developed Asia to experience slowdown in near term

The export-oriented economies (Singapore, Hong Kong, Taiwan and South Korea) are most likely to be impacted in the near term if US-Sino trade tensions escalate. Due to the high base effect from robust growth in 2018, slowing global trade and the electronics down cycle, developed Asia's GDP growth will decelerate in 2019 and 2020 and normalise towards their respective trend rates.

Japan's economic growth is expected to remain within trend<sup>9</sup> in the near-term. Its GDP growth of 0.8% in 2018 was partly impacted by one-off meteorological factors, as domestic consumption was stable. There are stronger economic headwinds for 2019 and 2020 as the outlook for exports remains uncertain. Domestic consumption and fiscal stimulus may provide a temporary uplift in 1H2019 ahead of a sales tax hike in October 2019, but

<sup>7</sup> United Nations Population Division; "World Urbanization Prospects: The 2018 Revision"; Jun 2018

<sup>8</sup> Global Economy and Development at Brookings; "The Unprecedented Expansion of the Global Middle Class: An Update"; Feb 2017

<sup>9</sup> Trend growth rate for Japan ranges from 0.5%-1.0%, according to the Bank of Japan's estimates

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economists are mixed on the outlook for 2020 with some expecting GDP to fall below trend due to the higher sales tax.

Over the medium-term, economic growth of developed Asia is likely to remain resilient. The ratification of regional trade deals like the CPTPP and Regional Comprehensive Economic Partnership (RCEP) and the relocation of Asian supply chains to ASEAN will benefit Singapore as a regional transshipment hub. Japan, South Korea and Taiwan may also be medium-term beneficiaries of higher-value electronics reshoring with intensified use of automation and IoT. Hong Kong looks to benefit from greater regional development with Mainland China as the Greater Bay Area takes shape, consolidating its position as an international financial, transportation and trade hub.

## Europe: The weakest link

### Mounting recession risks amid election cycle

As a single-market, the European Union (EU) is the world's second largest economy, accounting for nearly one-third of global output. EU-28's GDP growth slowed from 2.4% in 2017 to 1.9% in 2018 and the weakness could deepen in 2019. Downside risks stem from Brexit uncertainty, trade tensions, possible US tariffs on European auto exports and financial pressures in Italy. Adding to the mix is the increased threat of populism especially with several state and general elections across Europe later this year and the European Parliament elections in May. The European Parliament elections could also have implications on who replaces Mario Draghi as President of the European Central Bank and the direction EU monetary policy will take.

### "Flextension" of Brexit; uncertainty continues

The EU has agreed to extend Brexit to 31 October 2019 but with a review in June and an option for an earlier Brexit should the UK parliament agree on the withdrawal agreement. Even with this "flexible" Brexit, it is not clear how and when Brexit will happen. There is still a lack of consensus within the UK parliament on the Brexit path, increasing the possibility of another political process such as a second referendum or general elections to get the UK out of this Brexit impasse.

This uncertainty will continue to weigh on business and consumer sentiment and on UK's economic outlook. In the worst case of a no-deal Brexit, the UK economy could dip into a recession although a robust jobs market, easy monetary policy and a weaker GBP will mitigate the negative impact. In the medium to long term after Brexit, UK is still expected to be the world's 6<sup>th</sup> largest economy<sup>10</sup> and it should remain resilient as trading relationships are re-established.

### Euro area challenges

Elsewhere in Europe, challenges abound for other major economies despite the resilience of domestic demand. Germany narrowly escaped technical recession in 2018 as slower industrial production and external demand dragged down growth. Trade tensions remain headwinds to growth. Citi estimated that a 25% tariff on US car imports from the EU will lower

<sup>10</sup> Centre for Economics and Business Research, World Economic League Table 2019

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Germany's GDP growth by 0.1 percentage-point and 0.2 percentage-point respectively in 2019 and 2020.

France's economy was hit by "yellow vest" protests in 4Q2018 which affected consumer sentiment and spending and retail sales. Recently-announced measures to quell the protests and recovery in consumer sentiment will mitigate external headwinds. Italy already went into a technical recession in 4Q2018 and tightening financial conditions leave the coalition government limited fiscal headroom to boost growth further. In contrast, economic growth in Spain is expected to be more resilient and outpace euro area growth although political uncertainty in the form of snap elections in April and the Catalonia separatist threat cloud the economic outlook.

## **Real estate strategies**

### **Focus on the market fundamentals**

Barring unforeseen circumstances, APAC economies are expected to revert to trend or slightly above-trend GDP growth rates over the next two years, continuing to outperform the US and Europe. Monetary conditions in APAC are expected to remain accommodative to neutral, which will be supportive of real estate investments. Secular trends such as urbanisation, a growing middle class and improved connectivity through transport and communication networks remain fundamental demand drivers for high-quality real estate in the APAC region. If market volatilities persist or even exacerbate, more attractive investment opportunities may arise due to market dislocations.

### **1) Offices in key gateway cities**

Even as we enter the later stages of the market cycle, offices in selected submarkets can still be attractive, but investors should focus on income stability and sustainable rental growth rather than chase cap rate compression. For instance, Singapore, Sydney CBD, Beijing and Tokyo benefit from benign office supply pipeline over the next 2-3 years, which will be supportive of moderate rental growth if demand holds steady.

New decentralised supply is expected to remain elevated in Shanghai over the next two years, but selected CBD fringe clusters like the North Bund and Decentralised Business Districts (DBDs) such as Hongqiao Transportation Hub and Pudong Qiantan have emerged as attractive submarkets as the transport infrastructure and neighbouring amenities improve.

### **2) Follow the consumption upgrade**

While it is prudent to remain cautious over retail real estate at a time when global economies are slowing down and e-commerce penetration inching up, we believe there are still investment opportunities.

Besides more proactive asset management and place-making, malls catering to strong catchment areas with high propensity to spend or large accessible populations have a natural advantage. Well-managed malls in Shanghai and Beijing continue to benefit from rising disposable incomes and consumers' penchant for higher quality lifestyles. Healthy job markets in Hong Kong, Sydney and Melbourne support stable retail spending in well-managed malls.

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On the other hand, high-quality logistics properties are the biggest winners from the rise of e-commerce. Tokyo, Seoul, Tier-1 Chinese cities and their surrounding satellite cities remain the most popular destinations for logistics warehouse investments, given their proximity to end-customers. Demand in Australian cities on the eastern seaboard (Sydney, Melbourne and Brisbane) is also rising along with the growing acceptance of e-commerce and omnichannel retail. With public investments put into improving infrastructure networks, Jakarta and Ho Chi Minh City are also attractive locations for warehouses and distribution centres, given their respective rising middle class and growing e-commerce penetration.

### 3) Tap on growth of the data economy

The US-Sino trade conflict and the spotlight on 5G and AI highlight the importance of the data economy as the next frontier for economic development. While the battle to set the standards for 5G will continue, the world is already in the midst of a significant migration to cloud computing and AI adoption. Based on IDC's latest estimates, data creation is expected to grow exponentially at a staggering CAGR of 27% between 2018 and 2025. Within the APAC region, IDC expects cloud storage to double between 2015 and 2025, by which it will account for nearly 40% of the global market share. All these data will have to be stored in data centres.

We expect data centre leasing demand in the key gateway cities of Singapore, Hong Kong, Tokyo, Seoul and Sydney to remain robust. Demand in and around Tier-1 Chinese cities continues to grow, but foreign investors have to work with credible local partners with Internet Data Centre (IDC) licences. Land and power availability can also be challenging in certain areas. Across ASEAN, the growth of tech start-ups, rise of e-commerce, strong consumption of social networking and online media and data sovereignty laws are all supportive of data centre demand. In the emerging markets, we expect most of the hyperscale cloud providers' demand to be via colocation data centres rather than building their own hyperscale data centres.

## Conclusion

Global growth is undeniably slowing, but a global recession led by either the US or China is not the base case scenario, barring the proverbial black swan event. In the near term, monetary conditions remain supportive of growth, but we caution against chasing cap rate compressions and to instead focus on income stability and sustainable growth. In the event that market risks lead to price dislocations, more attractive investment opportunities may present themselves.

The APAC region remains the economic outperformer. Medium to long-term secular trends like urbanisation and growing middle class continue to underpin growth, further facilitated by required infrastructure investments. With the appropriate risk management and careful selection of target markets and asset classes, investors should look to maintain or even increase their exposures to APAC real estate.

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