Growth Moderation, But Not Much Of Worry

Replacement demand and numbers effect from SARS in Apr/ May 2003 lifted Singapore's GDP growth to 10%y/y in H1-04. While economic growth contracted 2.2%q/q (+7.5%y/y) in Q3-04, we were not too worried, as it merely statistical pay-back after the impressive figures in the earlier quarters. In fact, we expect such moderation to continue into the final quarter of 2004, with headline figure expected at around 6.3%y/y. The govt will release the Q4-04 figure at the New Year's Day speech. Nonetheless, the full-yr's figure should come in around 8.2% from 1.1% in 2003.

For 2005, it is essentially a story of 'global growth moderation', which will also guide Singapore's economic growth towards more sustainable levels. Besides the US economy moderating and the Japanese economy is also kind of losing momentum, it is clear that China's intention is to slowdown its heated economy. There are a few risks, however, that could lead to sharper than expected pace of moderation. These include the extent of slowdown in global electronics demand and the impact of SGD appreciation. Nonetheless, both risks are still manageable. While economists have started to revise down their Singapore's growth projection, with the latest MAS survey showing 4.3% growth from 5.0% in the last survey (about three months ago), our view is that the full-yr's growth should still be within the govt's 3-5% target range. UOB expects GDP growth of 4.2% next year.

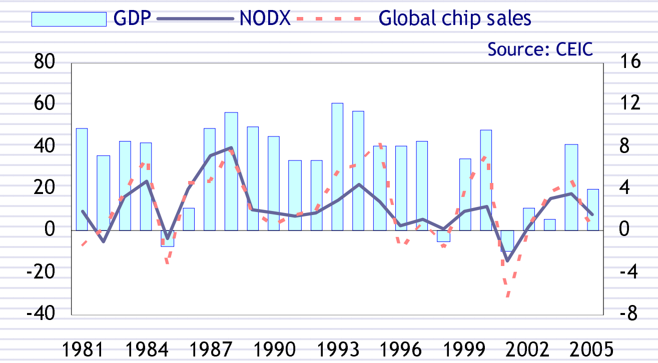
What are the numbers saying?

NODX has continued to moderate over the last few months, with headline figures at 11.9%y/y in Oct from 16.9%y/y in Sep and 28.9%y/y in Aug. Manufacturing figures have also fallen to 2.4%y/y in Oct from 12.5%y/y in Sep, mainly due to basis effect in the pharmaceutical industry and different product mix in the segment. Although electronics demand remained resilient, up 11.4%y/y in Oct, latest PMI figures indicate we could see sharper slowdown in the months ahead. After dipping 1.70pts in Oct, Singapore's PMI lost another 1.20pts to 50.3 -– lowest levels in 18 months and also 3rd straight month of declines. Specifically, new orders contracted at 49.20, the first time below the boom-and-bust mark in 17 months. Indeed, MTI has already narrowed its growth forecast to 8.0-8.5%, the weaker half of its initial 8-9% growth target, citing weaker bioscience, uncertainty in the oil prices and slower electronics demand.

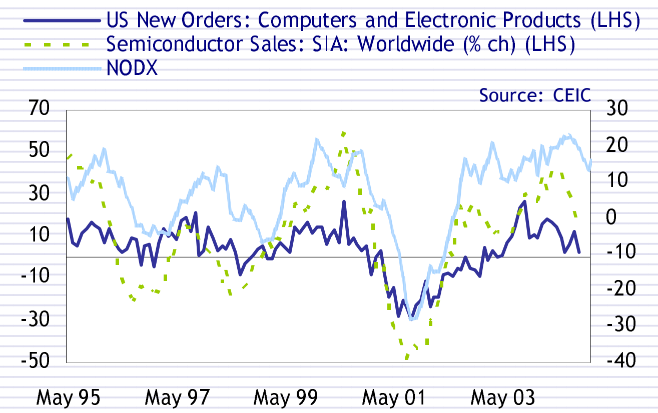
Global electronics demand –- The extent of slowdown?

With rising inventories and a more moderate outlook in consumer electronics demand, World Semiconductor Trade Statistics (WSTS) now expects growth to come in 1.2% in 2005. This is from an earlier forecast of 8.5% growth in Jul 2004. Indeed, demand of semiconductor making equipment is also set to dip almost 1% next year, according to Gartner. SEMI now expects chip-making equipment demand to shrink 5.2% in 2005, after growth of 59% this year. Still, consensus is that the decline will not be as sharp as the last two episodes, -9% in 1998 and -25% in 2001. Indeed, despite the contraction in demand for chip-making equipment, SEMI said the projection in absolute volume is still the 3rd largest ever. The agency expects growth to return to a modest 3.1% in 2006 and then 14.8% in 2007. WSTS expects demand to return to 3% in 2006 and then 11.4% in 2007. As to the sharp decline in capacity utilisation of foundry, expected to hit sub-70% from 90+% in

Global Electronics Moderating, A Drag To Singapore's Growth

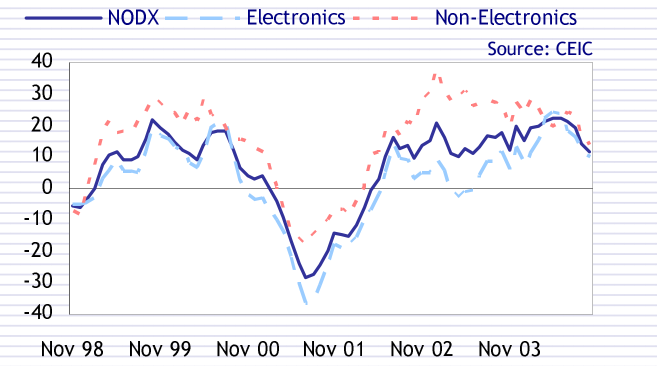


Moderation In Global Electronics



Quarterly Global Outlook - Q12005

Non-Electronics Provide Support For NODX



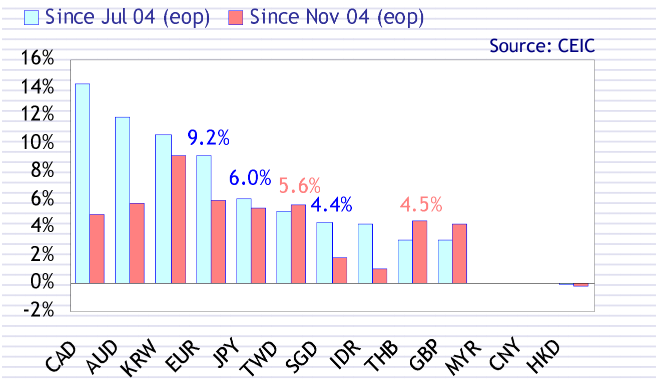
Q3-04, industry sources said it could be due to the quick response by manufacturers, especially after the painful experience in 2001. Indeed, it is precisely such adjustment that will reduce the likelihood of an excess capacity build-up and greater likelihood of a moderate cyclical decline in 2005.

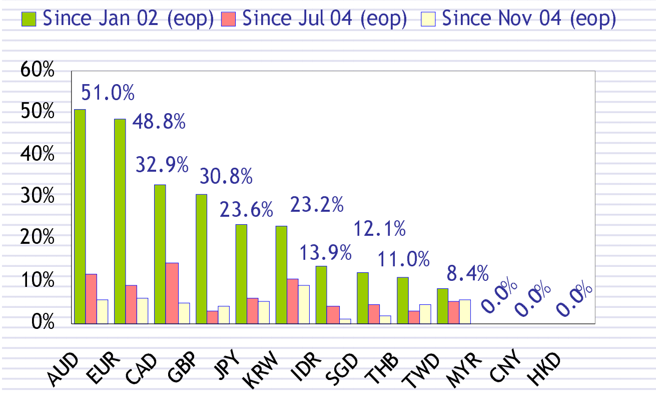
Singapore's growth has to a large extent supported by the strong global electronics demand this year, as global chip demand are expected to surge about 28% — highest over the last three years. While its contribution to domestic growth has declined over the years, electronics exports nonetheless still account for 55% of NODX. According to EDB, Singapore has 30 design centres, 19 chip test and assembly operations and 12 wafer-fab plants. In total, the semiconductor industry accounts for 13% of Singapore's manufacturing output and hired about 28,000 employees. While growth has also been supported by the bio-science industry, as long as global semiconductor sales do not go into the red, the full-yr's growth figure should still be well within the govt's 3-5% target range.

Impact of SGD gains -- No one is really talking about it

After hovering around 1.69-1.72 between May-Sep 2004, SGD appreciated about 5% to a 6-yr high of 1.63 in early Dec 2004. Exporters have raised concerns over the extent of the FX appreciation, which could bite into export competitiveness. To begin with, however, Singapore's exports have always been more responsive to global growth than FX adjustment. Indeed, our calculation revealed that income effect (global growth) is still about 2.8X more important than price effect (FX adjustment). Perhaps, more importantly, is renewed USD weakness and its impact on the global asset markets. So far, despite USD weakness vs majors of more than 25%, US assets markets have remained stable. Indeed, consensus is that USD weakness is needed so that the US economy will be able to avoid sharp correction eventually that could threaten global economic stability. Meanwhile, despite SGD strength of 5% since Jul-2004, SGD NEER has remained stable, up only 1%. This is due to offsetting effect via appreciation in other currencies, including TWD +5.6%, THB +4.5%, KRW +9.2%, JPY +5.4%, EUR +6.0% and AUD +11.9% over the same period. Indeed, the effect of SARS and the ERC's recommendations (including CPF cuts) were more talked about last year than SGD strength of 10% between Jan 2002 to Dec 2003. If any, the impact is probably related to sharp FX adjustment affecting corporates' decision-making process, which is quite difficult to quantify.

Global FX Performance





Additional supply side story –

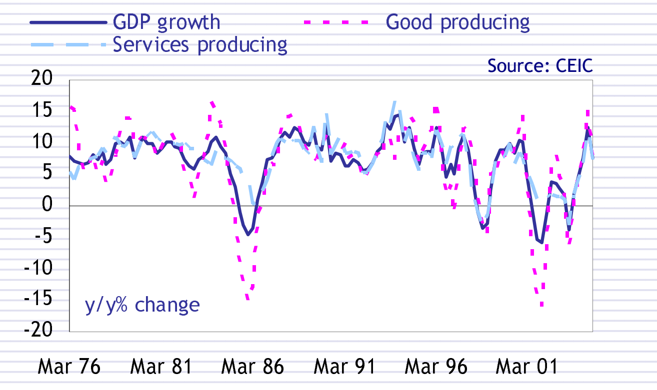
Wealth management and financial services industries

Besides bio-science industry, there have been more supply-side growth stories emerging for the Singapore economy. According to the MAS Survey, wealth management and financial services industries have been growing at an annualised rate of 26.3% between 1998-2003, as foreign institutions shift some of their wealth management business into Singapore, which should provide more cushions for the volatile electronics industry.

Domestic demand — more signs of recovery

Driven by the robust economic growth in the first nine months of 2004, unemployment rate fell to 3-yr low of 3.4% (s/adj) in Q3-04 from 4.5%. While jobs creation in the services sector was in line with recent trend, the surprise came from 8,800 employment rise in the manufacturing sector, which we be-

Singapore -- Besides More Supply-side Growth, Services Sector Has Traditionally Been Less Volatile Than Manufacturing Sector



lieve is related to producers finally taking on additional headcounts. However, this also means that further drop in unemployment is unlikely. Besides growth moderation into 2005, we believe earlier unemployed will start to enter the labour market. We expect unemployment back at 4% into 2005.

Growth moderation, but still ok

In all, moderation in global demand should bring Singapore's growth to a more sustainable 3-5% in 2005. Although there are concerns over the extent of global electronics demand, industry sources maintained that the fall-out will not be as severe as the 2001 episode, when demand fell 25%. As for the impact of SGS strength, our view is that as long as there is no major fall-out in the US assets market, the impact on Singapore's economy should not be too severe. Besides the usual argument that income effect is 3X more important that price effect, the fact is that the USD adjustment is needed to ensure that the US economy does not collapse in the foreseeable future. Overall, we maintain that Singapore's growth should come in within the govt's 3-5% target range. Although further moderation in global demand could push the headline figure closer 3.5-4.0%, UOB bias is that the full-yr growth should come in around 4.2% for 2005.

Inflation –- Edging up, but not too much of a worry

After two straight of months of price increase, Singapore's CPI levelled out in Oct, with headline figure up at 1.9%y/y in Oct 2004. While basis effect should drag down the headline figures into 2005, a few supply-side factors such as adjustment in university fees and transport costs, which have been frozen over the last two years. In its latest Macroeconomic Review, MAS highlighted pass-through from high commodity prices into 2005, along side with recovery in the labour market. The MAS is expecting inflation at 1-2% for 2005, with most market participants expecting headline at around 1.5%.

Policy implication –- MAS to maintain tightening bias

Latest MAS policy statement indicated that the balance of risk is tilted to3wards higher inflation into 2005, which justifies MAS tightening bias. Although growth momentum is expected to ease, MAS is likely to keep its tightening bias unless the full-yr figure starts to threaten the lower end of the govt's 3-5% target range. Indeed, at least for now, such risk is still very much contained, as reflected in SGD NEER firmly in the stronger half of the policy band over the last three months. Also, firmer SGD should help cushion the impact of higher oil and commodity prices. In all, unless global tech demand moderates further, it does not look like MAS to shift away from its tightening bias in 2005.