ARTICLE FOR THE EDGE

ECONOMIC RECOVERY COULD STILL SURPRISE POSITIVELY DESPITE THE OMICRON SPIKE

The emergence of the omicron variant of the covid-19 virus has dented the hopes of many that this would be the year when we would finally put the pandemic behind us. Infections are surging at an alarming rate in many countries, governments have had to re-impose some restrictions and economic activities have slowed as workers report sick or as ordinary folks cut back on going out. Yet, financial markets have taken the news in their stride, believing that the impact will be short-lived – even though this pandemic has frequently upset the optimists.

We think the markets are right to look beyond the omicron infection spike. More than that, we believe that the eventual rebound in global activity will be much stronger than expected. This is not only because we see the pandemic's effects on the world economy becoming less and less malign with time. The additional upside will come from the growing impetus for companies to move ahead with business development plans that had been suspended or delayed by the pandemic. This upbeat view does not ignore the downside risks such as a sharp slowdown in China or potential damage to economic vigour from monetary tightening in the US and elsewhere. Those risks need to be watched carefully but we believe that they are likely to be contained.

The pandemic will be less of a drag on global economic activity

Throughout history, pandemics like the one we are experiencing now exhibit a typical life cycle. They emerge out of the blue, cause great mayhem for a while and then evolve into progressively less harmful variants. Of course, there is no guarantee that this will always happen but in most cases, this is the pattern. Encouragingly, the behaviour of this omicron variant is very much in line with what the historical pattern of evolution would predict. It is highly transmissible but significantly less dangerous to health. Moreover, the experience in the countries which were first hit by the omicron variant – South Africa and the UK – suggests that the infections spike quickly and then fall away – as we are seeing in South Africa. After peaking at close to 40,000 infections a day in mid-December, the latest number is below 6,000. Hospitalisation and death rates have been remarkably low as well. If this pattern is repeated elsewhere, the worst of the omicron surge in infections will be over by the end of February or early March.

Extrapolating from this experience, our best guess is that even if further new variants do emerge, the likelihood is that the same pattern will present itself – the virus will progressively evolve into a less malign version. At the same time, medical science continues to surprise us by how quickly it can develop even better vaccines as well as better drugs to suppress the viciousness of the illness caused by the virus. All this makes the virus much less "scary". That means the health authorities will have less need to resort to measures that undermine the economy. And, consumers and businesses will not be terrified into cutting back on their

normal activities. The pandemic will not go away but it will progressively recede into the background, eventually becoming an irritation rather than a fearsome danger.

Why the economic implications are especially positive for Southeast Asia

The pattern of economic activity will follow a similar shape to the virus. In coming weeks, we will probably see some challenges for the economic recovery. The large number of infections will mean that many workers will not turn up for work. One report, for example, estimates that 3 million Britons were unable to turn up for work last week because of the surge in infections. Public health restrictions will reduce consumer and corporate activities. Business leaders may adopt a wait-and-see approach to hiring and capacity expansions. The recently released purchasing manager surveys are already picking up some of the resultant slowing in activity and suggesting some disruptions in the supply chains.

However, as the pandemic then subsides, there should be a rapid snap-back in consumption, investment and hiring. Economic growth will pick up swiftly as a result – which is what the markets are pricing in. But, our argument goes further. We think there will be additional impetus to demand that will spur the Southeast Asian economies to even faster growth.

The major reason for our view stems from our expectations for capital spending by companies in the major industrialised economies. Recent data show core capital goods orders continuing to grow in the US while picking up momentum in Germany. In America, a survey of small businesses showed a gradual improvement in plans to step up investments even though small firms were not happy with many aspects of President Biden's economic plans.

There are several reasons why we think that the rebound in capital spending will be much stronger than expected:

First, in the past two years as the pandemic disrupted the world economy, many new technologies have been reaching the points where commercial applications become feasible, and in some cases compelling or even unavoidable. Whether it is the cost savings promised by cloud computing or the productivity gains from using robots in factories or the decarbonisation promises of renewable energies such as solar, wind, hydrogen and geo-thermal or the revolutionary improvements in medical care offered by advances in the bio-medical sphere or the new possibilities created by new materials such as graphene or composites … the scope for profitable exploitation of new technologies has grown almost explosively.

Because these innovations are game-changing, companies cannot afford to miss out, failure to invest in these new technologies could render them obsolete. In addition, exploiting these new technologies will necessitate building new infrastructure which again means more capital spending. For example, if electric vehicles are to be one way of helping us reduce emissions, then we need to build massive networks of charging stations all over the cities of the world. Similarly, enormous amounts of investment will need to be invested in ultra-high voltage grids for electricity produced by renewable sources to be viable. Finally, new technologies also come

with new overhead requirements, which again require large amounts of investment. An example is cyber-security – companies cannot avoid investing in e-commerce, online payments and fintech but because of phishing, hacking, malware, ransomware and all those threats, they will have to invest heavily in cyber-security.

A surge in global capital spending will be positive for our region because the region's manufacturers specialise in the fabrication of components that are used in machinery and other capital goods.

Second, there are developments within the Southeast Asian region which point to further reasons why we could see an uptick in capital spending.

- The pandemic spurred companies to rethink how their supply chains should be organised. Relying excessively on China has been shown to be risky. China's zero-covid strategy has led to frequent dislocations in the supply chain. In the months before the pandemic hit, we had observed an increasing tendency for production to be relocated to Southeast Asia. That process was interrupted by the pandemic but we believe that it will resume with force once the pandemic subsides.

- In the past two years, the large amounts of fiscal spending needed to finance public health measures and to provide social security to the low-income groups have diverted monies from infrastructure spending which has therefore slowed considerably. We believe that there will be a substantial rebound in spending on power plants, roads, railways, mass transit schemes, ports and airports in the region as the year progresses.

- In the past two years, countries in the region have brought in reforms to improve their attractiveness to foreign investors. Indonesia, for example, passed a package of legal reforms that address issues which foreign investors had with Indonesia's labour market regulations and with caps on foreign shareholdings.

What about the risks?

Our major concern is China where a confluence of headwinds has emerged. The property sector downturn continues to rumble on, which aggravates the financial difficulties faced by large borrowers, even those outside the real estate sector. Private entrepreneurs have been shaken by sudden regulatory shifts that have dimmed prospects for many tech companies as well as sectors such as education. If private companies shun capital spending as a result, the implications for the Chinese economy and the world economy could be serious since investment accounts for more than 40% of the economy. China's unrelenting zero-covid strategy is also a risk – sudden lockdowns of whole cities including ports and industrial estates can dislocate supply chains that the world's manufacturers rely on.

However, China's highly regarded policy makers are stepping up their support for the economy. Just this Monday, the State Council called for measures to boost domestic demand while senior economic policy makers have urged measures to ensure that employment is

propped up. In the past month, the central bank has also been extending more support to vulnerable segments while working behind the scenes to ensure that the fallout from defaulting property companies can be contained. As a general rule, it is not a good idea to assume that policy makers will get things right all the time but the formidable track record of the policy makers in Beijing do provide some comfort. The latest purchasing manager surveys showed tentative signs that the economy was regaining momentum so it appears that the measures taken are beginning to secure the economy.

A second concern is the turn in monetary policy in the US and other developed economies. The US Federal Reserve Bank has pivoted quite dramatically in the past couple of months – we will probably see not just an end to quantitative easing but actual reductions in the liquidity provided by the Fed by March, when the Fed will also start raising interest rates. The European Central Bank and the Bank of Japan have also indicated that they will shift away from the ultra-easy stance of the past two years. There are no two ways about this – tighter liquidity will eventually hurt financial asset prices. Excesses have probably built up in financial markets in the past couple of years, whether it is the excitement over crypto-currencies or the aggressive valuations of tech stocks or the big increases in property prices across the globe. Nevertheless, central bankers seem quite aware of the potential risks and are likely to calibrate their policy shifts very carefully, which should help limit the damage from tighter monetary conditions.

Conclusion

The current difficult patch in the global economy is likely to be short-lived. It is likely to give way to a period of robust global expansion. The patterns within this recovery should benefit the Southeast Asian region, so long as risks such as the slowdown in China and the end of easy money are managed.

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