

Good MornING Asia - 06 June 2018

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By Robert Carnell



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Nothing to get your teeth into

After Monday's inexplicable rally, aside from a lack of bad news, Tuesday showed that you need a bit more substance to keep the positive momentum going and there are enough worries out there to keep markets from relentless gains.

Trade is, of course, one of those worries. But aside from some vague comments about US bilateral deals with Canada and Mexico that sound as if they would circumvent NAFTA, there isn't much to talk about here. These headlines also have just the sort of "Trump-feel" that suggests they are nothing more than a negotiating ploy - divide and conquer! These are becoming a bit obvious now. We suspect both Canada and Mexico can see this for what it is too. It isn't rocket science.

US Trade figures for April are due out later today, and these may provide Trump with some further fuel for ranting tweets and unhelpful tariff threats. The calm may not last long.

The only other potentially interesting rumour is that the ECB is allegedly back to using the June 14 meeting to signal timing on the end to their QE purchases. Coming the day after the Fed is expected to raise rates again, any EUR appreciation that follows should be able to be contained at acceptable levels, and any dollar rally after the June 13 FOMC might prove fleeting to say the least.

A lack of eurosceptic craziness so-far from the new Italian government is surely helping to provide a calmer backdrop for ECB President, Mario Draghi to have another go at ending a policy that is as far past its shelf life as an over-ripe gorgonzola.

Chat rises about BoJ exit

With the ECB maybe eyeing a way out of their current QE quandary, we expect the BoJ to be looking to capitalize on this and use the distraction in Europe to do something similar of its own. Masahiro Kawai, an adviser to Bank of Japan (BoJ) Governor, Kuroda, has suggested that yen weakness associated with further US Fed rate hikes could be countered by raising the BoJ's current bond yield target. He even gave a couple of lines in the sand at USDJPY125 and USDJPY130. We are miles off those level today at 109.90, but the fact that chat like this is beginning to emerge is probably not meaningless.

However, it will be a lot easier for the BoJ to sell a change in policy in a tightening direction if other parts of the economy are looking healthy, and household wages are a key element of this. Today's labour cash earnings for April rose a disappointing 0.8% (expected 1.3%) after the 2.0% gain in March, though most of this seems to have been bonus related, and the more impactful contracted regular earnings rose 1.2%YoY, unchanged from March, but showing a modest pick up from growth rates a year ago.

Eyes down for Reserve Bank of India

We are part of a small minority looking for the RBI to raise rates today by 25bp. Rising fuel prices and the likelihood of a CPI overshoot later this year, as well as rupee weakness, are the underlying reasons for our call. The consensus may be looking at the current inflation rate which is running at a fairly respectable 4.58%YoY (April), but we think this is a bit backward looking. Also, if the RBI wants to put a little rocket fuel under the rupee, it will get more bang from an unexpected hike than one that is fully priced in. For that reason, a move now makes sense. There is also some merit in the "a stitch in time saves nine" approach to monetary policy. Which for those of you unfamiliar with knitting terms, simply means that you can sometimes manage more for less by acting in a timely manner, rather than a rushed response to weakness later.

Misuse of statistics

"Global growth set to ebb" - [says a headline](#) about the latest World Bank global GDP forecasts. The forecasts for 2018 and 2019 show growth of 3.1% in 2018 and 3.0% in 2019. The rationale for the forecast dip is rising interest rates and an approach to full output. I don't have any problem with that, though I would add the effects of a sharp fall in US fiscal thrust coming the year after the Trump tax reforms, and the potential for the Trump administration to destabilize global growth with aggressive trade protectionism. That ought to do it. But if so, it won't be a 0.1pp difference. That is a rounding error. Anything less than 0.5pp isn't really worth a comment.

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China: Why the central bank won't cut reserve requirements

China's central bank is supporting the onshore bond market by expanding collateral for the medium-term lending facility (MLF). This will reduce contagion risks though standalone default cases could continue. Still, we think it's unlikely the central bank will cut its reserve requirements ratio (RRR) for banks in June. Here's why



Source: istock

Central bank expands collateral of medium-term lending facility

Since 1 June, the central bank (PBoC) has expanded the collateral of its medium-term lending facility (MLF), which is a lending facility for banks.

MLF collateral expands to:

1. AA-rated bonds issued by financial institutions for small and micro enterprises, green financing and agricultural financing.
2. AA+, AA-rated corporate bonds (priority to accept bonds involving small and micro enterprises, green economy).
3. High-quality micro-enterprise loans and green loans.

Before this expansion, the central bank only accepted sovereign bonds, central bank notes, China

Development Bank and other policy bank bonds, local government bonds and AAA corporate bonds as collaterals for MLF. The interest rate on MLF is now at 3.3%.

Limiting contagion risks

By doing so, China's central bank is comforting the onshore bond market.

In the past, bonds issued in China were rolled over without any issue. However, as the central bank tightens liquidity to accomplish financial deleveraging reform, maturing bonds have become increasingly difficult to roll over, especially for companies that have weak financial backgrounds.

Collateral expansion for MLF would reduce contagion risks and calm the market, however, we still expect standalone default cases, especially for companies with weak financials as financial deleveraging reform continues.

As of 1 June 2018, some 22 bonds had defaulted involving seven issuers, totalling CNY20.2 billion according to [Securities Daily](#). Though the number of issuers and default amount look small, default risk is rising in the onshore bond market.

According to [ChinaBond](#), on 1 June, the three-year yield spread between AAA-rated and AA-rated credits widened to 76 basis points, much higher than around 30 basis points at the beginning of the year.

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Short rate reflects tightness of liquidity



Market expects PBoC to cut RRR and let banks repay MLF in June

For the whole of June, there are CNY920 billion of [reverse repos](#) and CNY259.5 billion MLF maturing, in addition, June marks the half-year point. It looks as though liquidity will be extra tight in June.

The market expects the central bank to cut its reserve requirements ratio (RRR) to replace the higher-cost MLF borrowed by banks, a repeat of April's monetary policy after MLF collateral expanded.

Here's why we don't agree with the market

We believe that it is unlikely for the central bank to repeat its April action in June.

- First, expanding MLF collateral implies that the central bank is going to extend more MLF to banks, and banks would get extra liquidity.
- Second, expanding MLF collateral should have an immediate impact on the bond market. It should be easier to roll over maturing bonds as there will be extra liquidity, and this should improve sentiment in the bond market. So there is no imminent need for the central bank to cut the RRR, which may send the wrong signal to the economy that the central bank's monetary policy favours easing over deleveraging.
- Third, expanding MLF collateral and at the same time cutting RRR to repay the MLF complicates the monetary transmission mechanism. Put simply, the actions would induce the market to put up lower-rated corporate bonds as collateral to borrow more from the central banks, and then repay higher-cost borrowing (at 3.3%) with low-return RRR money (at 1.62%). This would distort the efficiency of credit in the whole economy.

Our forecasts on monetary policy in June

We believe that a better way to smooth out seasonal liquidity tightness is to rely on daily open market operations with different tenors, so that liquidity would increase directly and would only be short term to cross the half-year end. At the same time, the market would get a consistent message that liquidity will remain tight as financial deleveraging continues.

As mentioned, expanding MLF collateral would probably induce more MLF lending. This should replace the maturing CNY259.5 billion MLF.

These two actions should be enough to smooth out liquidity tightness created by seasonality and negative bond market sentiment.

We also expect the central bank to follow the Federal Reserve in hiking rates in June to maintain the interest rate spread between China and US. But given that liquidity is already tight, PBoC's rate hike would be a modest five basis points.

A repeat of April's central bank action would be more likely in the second half, as officials need more time to see the impact of its MLF collateral expansion on bond market liquidity.

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Philippines: May inflation surprises on the downside

The May inflation rate of 4.6%, which is at low end of central bank forecast, reduces pressure to hike policy rates later this month. Uncertain second-round effects should keep BSP vigilant



Source: Shutterstock

4.6%

Lower than expected

Inflation in May

MoM disinflation for food and utilities

Lower-than-expected May inflation could delay further central bank tightening

May inflation surprised on the downside as food, non-alcoholic beverages and utilities posted MoM disinflation. This brought annualized headline inflation to only 4.6%, below the market's median forecast of 4.9% and at the low end of Bangko Sentral ng Pilipinas (BSP's) forecast of 4.6% to 5.4%. The government encouraged rice millers in the major rice producing regions to sell some inventory at a 10% discount to April prices. Tighter monitoring of retail prices also helped. We anticipate that

the delivery of government imported rice to major ports this month will bring back low-priced subsidized rice to the market and offset other price pressures. Oil prices have eased also but a weaker PHP is likely prevent the full translation of the drop in global oil prices at the pump. We believe that recent developments indicate that inflation is at or near the peak. These developments also cut the pressure on BSP to hike policy rates this month. However, we still expect BSP to hike policy rates at the 21 June meeting to pre-empt second-round effects and stabilize inflation expectations. Tri-partite regional wage boards are considering higher minimum wages while regulators deliberate on higher minimum transport fares. BSP's 4.6% and 3.4% 2018 and 2019 inflation forecasts assume a 3.6% increase in minimum wages and a modest increase in transport fares. Significantly higher increases may result in a double peak of inflation while keeping inflation expectations on an uptrend. The other consideration is a weakening PHP. Further weakness could still push prices higher. Manufacturers have signaled price increases to cover higher costs resulting from higher oil prices and a weaker PHP. While we argue for a rate hike this month, the likelihood is now closer to even.

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