

Good MornING Asia - 1 August 2019

Asian markets are likely to follow their US counterpart lower after Fed Chairman Powell dampened hopes of an aggressive easing cycle ahead.

In this bundle



Fed's Powell delivers "hawkish cut"

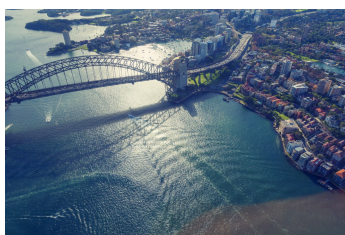
Dollar rallies, the curve flattens, stocks sell. There's more coming, but not much, so don't hold your breath.



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Fed's Powell delivers “hawkish cut”

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Source: Shutterstock

2.0-2.25%

New Fed funds range

Down 25bp

As expected

Powell does what he needed to do...

Before you read my brief and personal thoughts on last night's Fed move, [here is the more detailed and insightful official house view from James Knightley](#).

It may not have pleased the US President, he has been tweeting again, but I think Jerome Powell can regard last night's Fed decision as good progress towards the goal of stabilizing the US expansion, whilst at the same time, not goading markets into pricing even more easing in. Lessons learned from the RBA's recent similar performance, possibly?

What we have seen with the Fed's 25bp rate cut, taking the target range down to 2.0-2.25%, and the cessation of balance sheet roll-off - as of today - is a slight repricing at the front end of the curve, and a bit more rallying by the back end - probably an equity market spillover as stocks have

taken umbrage at the lack of promise of a string of easing.

Fed funds futures now price an implied yield of 1.47% in December 2020, and 1.83% in December 2019. That is up from two days ago when the respective yields were 1.40 and 1.785%. These aren't big moves, but there is likely more of this to come as the message that all that may be coming is another 25bp, and perhaps not immediately, starts to sink in.

The dissension by two voters, Esther George and Eric Rosengren, underlines the fact that as rate easing goes, this is likely to be more "nouvelle cuisine" than "all you can eat".

For the [Fed's statement](#) and the [following Q&A](#), please click the links.

End of quantitative twaddle

Now for the ranty bit.

The Fed will, as of today, stop allowing maturing assets on their balance sheet to roll-off, and will instead, re-invest their proceeds. This is happening about two months earlier than originally planned, as the original plan was to end this at the end of September. This is not a big deal.

The end of quantitative tightening? Don't make me laugh. It was never any such thing. If it had been, then we would have seen 10Y Treasury yields at uncomfortable highs, not struggling to stay above 2.0%. The latter stages of QE in the aftermath of the financial crisis had arguably no meaningful effects on either asset prices, expectations or the real economy (NB I do not write off the earlier actions, which were a useful firebreak).

It makes no sense at all to assume that simply allowing these bonds to mature, would do anything meaningful in the opposite direction. The later stages of the asset accumulation by the Fed did little if anything on active buying policy the way up. We should not imagine it would do anything as their asset holdings make their way passively down again (and a lot more sedately than on the way up).

It's not like the Fed has been aggressively selling down its balance sheet. The term "quantitative tightening" is a horrible misnomer and should be immediately and forevermore consigned to the lexicographer's trash can.

End of ranty bit.

Asia's response

Asian stock futures are mainly showing red today, currencies are more of a mixed bag, with the SGD and AUD looking particularly soft against USD strength, whilst the higher yielders don't seem to have responded as much. The THB is also showing uncharacteristic signs of weakness, perhaps reflecting the recent manufacturing weakness and surging balance of payments, reflecting the lopsided domestic / export balance of the economy, and likely further weak inflation today.

Like the BoK, another reluctant easer, the Fed's actions make some easing from the Bank of Thailand look all the more probable, and in our view, rate cuts can come as early as this month. We still see scope for an early move from the Monetary Authority of Singapore, perhaps softening markets up for a further move in October. And of course, we anticipate more from the BoK, and respective central banks in Indonesia and the Philippines may not be far behind.

So in the absence of much good news flying around currently, I would put the Fed's overnight cut and subsequent likely further modest easing into the basket of "welcome market developments". The US economy remains in decent shape, the Fed's easing now and later makes the continuation of that positive story more probable. So rather than sell-off in disappointment at the absence of a big easing cycle (which would probably mean a recession was on its way), as some markets are doing, this is a story that should make you want to be longer positioned in risk assets. A buying opportunity?

Trade talks end after half a day

It was barely worth the flight from Washington to Shanghai. Trade talks between the US' Robert Lighthizer, Steven Mnuchin and China's Vice Premier, Liu He, ended yesterday and will not resume now until September.

Chinese officials have described the pressure from the White House in advance of these talks as "meaningless". Though the White House later described the meetings as "constructive".

The issues, that are making these trade talks hard to conclude are not likely to be any less difficult in September. We are not holding out much hope of a breakthrough then either.

More inflation data ahead

As well as Thai inflation later today, we have already had Korean inflation for July, which has delivered a disappointing 0.6%YoY reading, down from 0.7% in June. The core reading was a bit better. But this data still adds to the sense that the BoK has more easing work to do. As does the export data also just out today. July exports fell a further 11.0%YoY, with semiconductors falling 28.1%YoY.

If you want to make a good news story out of this, it is that in levels terms, it looks as if semiconductor exports troughed in February of this year. But their passage since then has been pretty flat. I do not believe we can yet point to any sort of cyclical, or even just seasonal upswing. But the end of the decline is at least something to cling onto.

PMI data dominates the rest of the day here in Asia, with the Chinese Caixin survey worth a good look after yesterday's unexceptional official numbers.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

ASEAN Morning Bytes

General market tone: Risk-off. Asian markets are likely to follow their US counterpart lower after Fed Chairman Powell dampened hopes of an aggressive easing cycle ahead.



EM Space: Powell disappoints doves, traders to pull back on Thursday

- **General Asia:** We see little in a slew of Asian economic data today to change the course for the regional markets, which are likely to follow their US counterpart lower after Fed Chairman Powell dampened hopes of an aggressive easing cycle ahead.
- **Indonesia:** The International Monetary Fund (IMF) forecasts Indonesia's growth to hit 5.2% in 2019 and 2020 on steady investments and domestic demand. Furthermore, the IMF sees scope for further central bank policy easing, which squares with similar hints from Bank Indonesia's Governor Warjiyo.
- **Thailand:** We expect today's July CPI data release to show a further dip in the inflation rate to 0.8% YoY from 0.9% in June (consensus 1.0%) with the continued decline in transport prices outweighing rising food price inflation due to drought. Meanwhile, June current account surprised on the downside with \$3.9 billion of surplus, though still forms a key driver of the currency strength. Even if the THB appreciation was nearly stalled in July, the year-to-date 5.8% gain has been keeping imported inflation from global oil price at bay. We believe the economy is screaming for stimulus and we are convinced that the Bank of Thailand will follow the US Fed in cutting rates next week.

- **Philippines:** The Bangko Sentral ng Pilipinas (BSP) forecasts inflation for the month of July to settle between 2.0-2.8% as prices for rice and utilities slide on improved supply conditions and lower global crude oil prices. With continuing to be tame, we expect the BSP to cut policy rates next week as GDP growth likely to have stayed below 6% again in 2Q.

What to look out for: Trade talks and US NFP

- Taiwan PMI manufacturing (1 August)
- China Caixin PMI manufacturing (1 August)
- Thailand inflation (1 August)
- Hong Kong retail sales (1 August)
- US ISM manufacturing PMI (1 August)
- Indonesia inflation (1 August)
- Malaysia trade (2 August)
- US non-farm payrolls (2 August)

Author

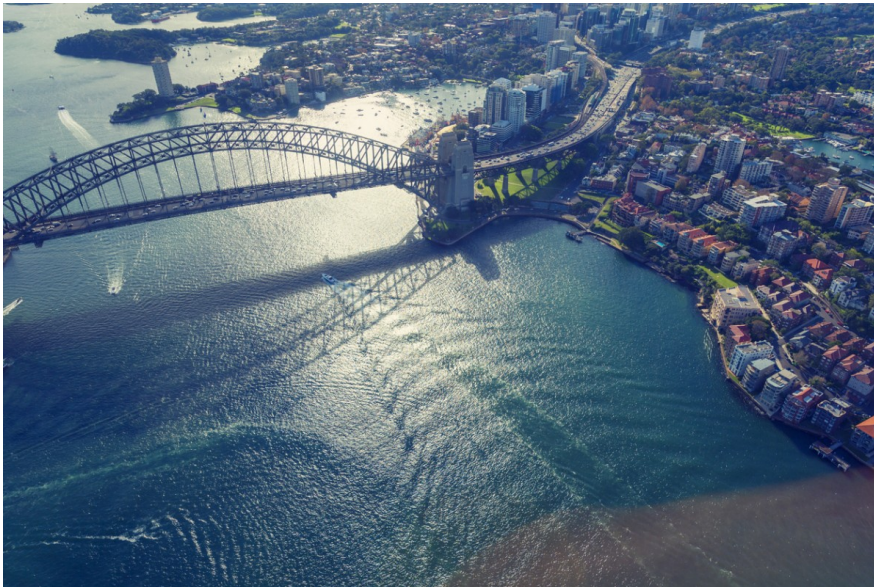
Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Australian 2Q19 CPI takes pressure off Reserve Bank

Despite recent dovish remarks from Reserve Bank (RBA) Governor Lowe, the improved CPI figures for 2Q19 take the pressure off any need for an imminent follow-up to recent back-to-back easing.



1.6%YoY

Higher than expected

2Q19 inflation

Up from 1.3% in 1Q19

Higher inflation, but still way below target

Australia's Central Bank (the Reserve Bank, RBA) has a tougher job than most central banks around the world, given that it targets an inflation range with a mid-point half a percentage point above most other developed-market central bank inflation targets .

So today's rise in the headline inflation rate to 1.6% in 2Q19, represents a welcome directional shift given the steep drop to 1.3% in 1Q19, but leaves a still substantial gulf to be filled to get inflation closer to the medium-term target.

RBA outlook - nothing for now

So what does this mean for RBA policy?

In the short term, it means that the back-to-back cuts, with the most recent at this July's meeting, are probably enough for now. The government's tax cut package passed parliament this month too, which will deliver a tax rebate of AUD255 to AUD1,080 for many earners on tax returns now being filed. That should provide a lift to spending, and hopefully, in time, employment, wages and inflation. That said, these transmission channels are a lot weaker than they used to be, so the full extent of the outcome remains uncertain.

The RBA has not been silent on its view that fiscal policy needs to do its share of the heavy lifting to bring economic growth, employment and inflation back to a more reasonable path, and whilst it waits to see how this pans out, there seems little prospect that the RBA will need to provide any further monetary stimulus.

Longer term - possibly another cut

We still have a further cut penciled in for 4Q19. This isn't a particularly strong conviction call, especially in terms of the timing. But recent dovish comments by Governor Lowe indicate that the RBA may not have quite finished its easing yet. While we wait for the impact of the earlier monetary easing and the forthcoming tax rebates, we will retain a cautious outlook for policy, though it may be that we end up shifting this cut back into 2020, or even removing it entirely if the economic backdrop improves sufficiently.

Markets are still fully pricing in a further rate cut by the year-end, with a further cut of the cash rate to 0.5% partly priced in. This sounds too much for us.

Author

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebvre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

China's PMI shows two opposing forces in manufacturing

After a brief rebound in March and April, the official manufacturing PMI in China has been contracting for three consecutive months. We expect that this downward trend in manufacturing will continue in 2019 until the trade and technology negotiations make some progress



New orders and export orders led the contraction

China's headline manufacturing PMI continued to contract, though the slight rise in the index to 49.7 from 49.4, suggests a slower rate of contraction than before.

Within all the subsectors of the PMI, orders are the main indicators of future manufacturing strength. New orders and export orders were 49.8 and 46.9 respectively, though edging higher from the previous month, which saw 49.6 and 46.3, respectively. Both indices remain below 50. That is, manufacturing orders are still falling but at a slightly slower pace.

We expect two opposing manufacturing forces in China

We see two opposing trends in the manufacturing sector, one for export-related industries, another for infrastructure project related industries. This is also evident in industrial production and fixed asset investment data.

Export related orders will continue to be dim

Export related orders, including technology exports, e.g. semiconductors, have been falling due to the trade and technology war.

Infrastructure related and self-development of high tech will boost PMI

In contrast to export orders, we expect that infrastructure-related orders will rise after the funding is diverted to infrastructure projects. This is indicated by the rising raw material price index (50.7 in July from 49 a month ago).

As long as China cannot import technological components (due to Chinese companies' inclusion in US' entity list), it has to invest to develop its own, which will also create domestic orders for electronic parts and goods. Eg. from the National Statistic Bureau, computation equipment's PMI was above 51.0 in July.

We expect the manufacturing PMI to gradually improve from domestic demand.

We expect domestic demand will boost some parts of the manufacturing sector. But it is still too early to judge whether the manufacturing PMI will overcome the contraction trends and revert to a figure of 50 or higher, representing expansion. Forthcoming activity data will shed more light on this question.

Author

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Hong Kong's future amid protests and a trade war

Hong Kong GDP rose 0.6% YoY in the second quarter, the same as in the first. The latest numbers reflect the impact of the trade war but don't take into consideration the effect of the recent political demonstrations on retail sales and associated jobs. We expect weaker data in 3Q as the protests could well continue at least until local elections in November



Mass protests in Hong Kong are having an economic impact

GDP report is weak for 2Q but that's just the beginning

- GDP grew 0.6% YoY in 2Q, the same very slow growth rate as seen in 1Q. The low base effect in 2Q has not given a boost to GDP growth.
- Investment is key to Hong Kong's future but its growth rate has gone down further to -12.1% YoY from -7.0% in 1Q.
- Consumption grew by 4.0% YoY, which was slower than the 4.5% growth seen in 1Q.

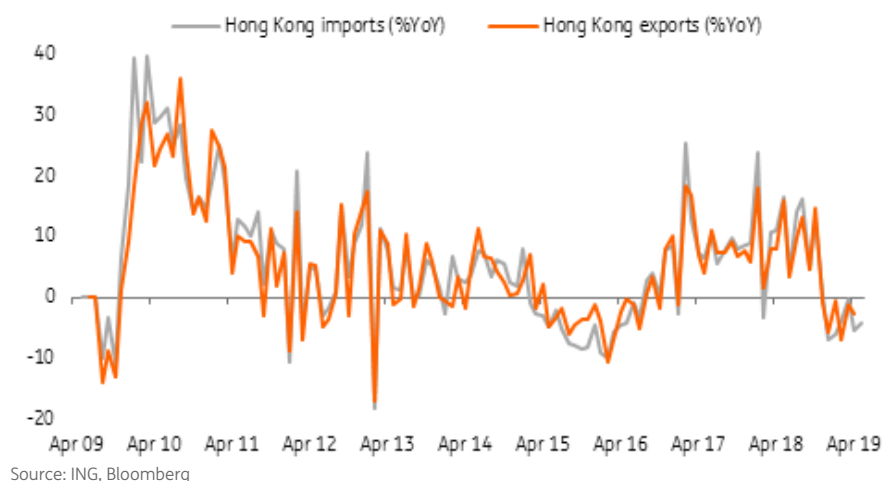
The direct damaging impact of the trade war

Tensions from the US-China trade war have hit Hong Kong's import-export environment. Total import and export volumes fell by 7.6% in 2018. Freight volumes will be lower in 2019. Moreover, the number of companies engaged in this industry has decreased by 1.5% year-on-year and by about 1% quarter-to-quarter, reflecting the issue of negative investment.

This fall in the number of firms also means fewer people are working in the industry. Employment in the sector fell by 3.6% year-on-year in March and was down by 2.8% quarter-to-quarter. In addition, the number of job vacancies in the industry fell in March by 10.5% year-on-year and was down by 3.2% quarter-to-quarter. Employment in this industry makes up 17% of the total employed population in Hong Kong.

As such, the impact of the US-China trade war on Hong Kong cannot be ignored. Trade-related industries' wage growth and job security will be at risk for the rest of the year.

Hong Kong export-import in contraction due to trade war tensions



Retail sales and tourism hit by protests

Retail sales in Hong Kong have suffered from four months of contraction. A further slowdown is increasingly likely for the rest of 2019 from slower wage growth in export-import trade as well as from protests that shorten shops' business hours, which could also hit employment in the retail industry. Less employment in the import-export sector will also weigh on the retail sector.

The protests are also directly affecting retail sales. Whether it is a small shop on the street or a shopping mall, most of them have had to shorten business hours as they wait for the protestors to leave. People working in the retail industry are also consumers. Retail makes up 8.4% of labour, and with the tourism industry, they make up a combined 15.8% of employment. When these consumers spend less then more shops will face increasing risks of closure; it becomes a vicious cycle.

I want to make an economic comparison between the political unrest to the period that Hong Kong

was hit by the deadly SARS virus in 2003. Then, the unemployment rate was as high as 8.4%, a record for Hong Kong, and economically, there are similarities:

1. Consumers stay at home, instead of doing shopping, even during weekends or public holidays.
2. Shops shorten business hours or even close.
3. The two events last for more than a month.
4. Tourists avoid visiting Hong Kong

Though we do not believe the protests will hurt the retail industry as hard as SARS, if and when protests become more frequent (not just from Friday evening to Monday dawn). when they last longer than several months and as the become increasingly more combative, there will be even fewer shops open and there will be fewer consumers spending their money.

In short, the retail industry will continue to struggle until the end of the summer holiday or even until the local elections on 24 November.

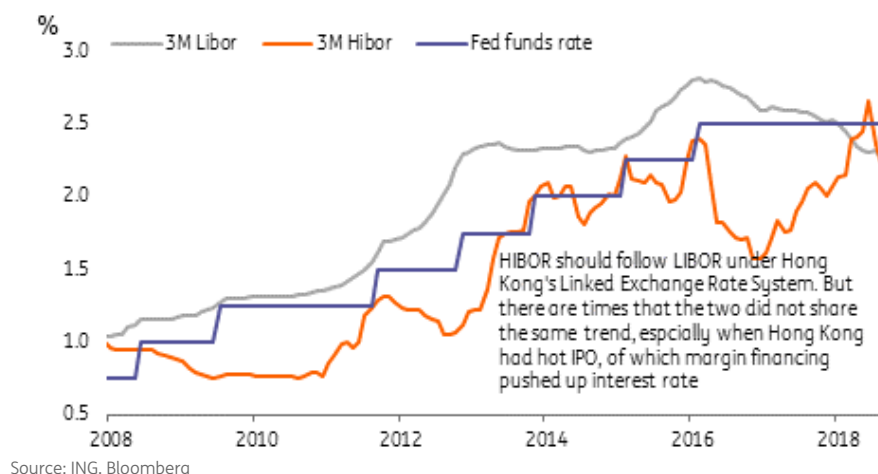
Hong Kong interest rate trend to follow the US, only generally

Because of Hong Kong's linked exchange rate, Hong Kong's interest rate trend is roughly in line with US interest rate movements, so HIBOR will follow the trend of LIBOR.

The market estimates that the Fed will cut interest rates two to three times during the remainder of 2019 (our house view is two cuts from the Fed). When the US cuts interest rates, the chances of interest rate cuts in Hong Kong's loan interest rates rise.

However, the current banking competition in Hong Kong is fierce and heavily affected by IPO margin financing. The overall borrowing interest rate could not necessarily be lowered. For example, when there is a hot IPO, margin financing will push up HIBOR even when LIBOR falls because of a Fed rate cut.

HIBOR does not always follow LIBOR



Property market is not going to shine even if the Fed cuts rates

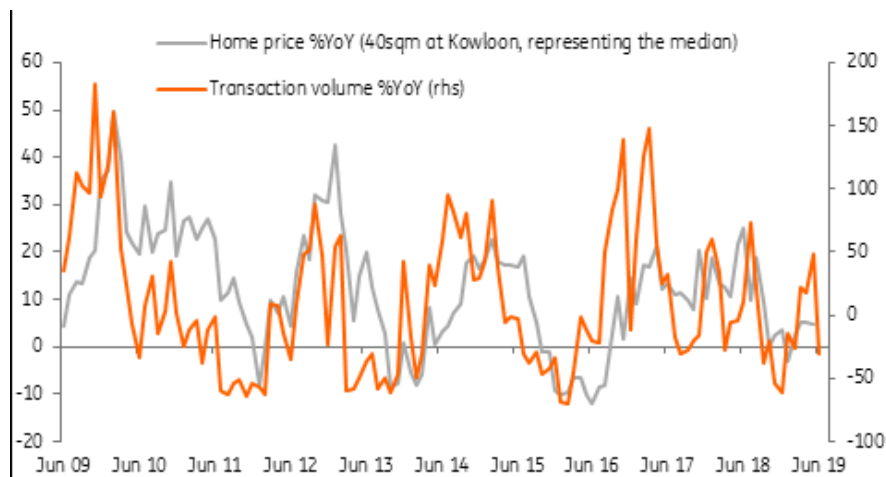
However, if the interest rate on a mortgage is linked to HIBOR, the borrower should be able to enjoy

a lower interest rate. So, is a Fed rate cut helpful to the property market? Not necessarily. Interest rates cuts usually reflect the central bank's view on the outlook for the economy. The Fed's cut is no difference. That is, the Fed is not necessarily optimistic about future economic growth.

In addition, the above analysis of a possible deterioration in the Hong Kong job market implies that investors will be more cautious when they invest in retail residential properties as well as offices.

The property market could be quiet for a while. If the number of unemployed or underemployed people continues to rise, I believe that there may be cases of bank foreclosures which will further depress property prices.

Residential property price and transaction volumes



Source: ING, Bloomberg

Hong Kong economy in 2H19

We expect GDP in 2H19 continue to be weak. The good news is that the base effect will give a boost to the year-on-year growth rate.

With the base effect, Hong Kong GDP could grow around 1.4%YoY in 2H19. This is a revision from our previous forecasts of 2.0%YoY and 2.5%YoY in 3Q and 4Q, respectively.

We also revise the full year GDP growth to 1.0% from 1.8%.

Two factors to look for for the rest of the year:

1. Progress on the trade war, which will affect the import-export business between China and Hong Kong.
2. The frequency, duration and combative nature of the protests which could well carry on through the summer

Unless these factors fade, the Hong Kong economy will be weaker in the second half of the year.

Author

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

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