Good MornING Asia - 1 July 2020

No intermission, no glass of bubbly, just straight into the second half of 2020. And the outlook...? Better than the first half, but not as good as it could be

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Welcome to the second half

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Source: Shutterstock
Calendar

Covid-19 not dominating, but maybe that will change

Looking at the news on Covid-19, it is hard to maintain a rosy disposition to the second half of 2020. Dr Facuci last night warned of the US daily new case numbers potentially hitting 100,000 a day before long if social distancing is not more rigorously adhered to. Mask wearing still seems pretty optional in many places, or a political statement in others. It isn't. It may save your life or the life of others. And the FT also had a story suggesting that 40% of the US by population were either experiencing backtracking on re-opening or pauses in plans to re-open. This puts an additional dampener on the outlook for the economy above the self-isolation that is probably increasingly being practised in some areas. With 2H 2020 supposed to see a big pick-up after abject 1H weakness, I suspect such thoughts could be pared back a bit in the coming weeks.

The rotten cherry on the top of this rancid dessert was a statement from the Federal Communications Commission, which is reported as declaring Huawei and ZTE as national security threats - another salvo in the US-China Trade/tech war, which shouldn't help to improve risk sentiment.

Not for the first time, some markets saw things differently. The S&P500 finished up yesterday, though futures showed expectations for gains to be trimmed today, which may soften any optimism in Asia at the opening. Government bond markets and gold took a slightly more (in my opinion) realistic view, with gold moving above $1800/oz, partly on the risk outlook.

Loads of data

We've already had quite a lot of data for the Asia region this morning, with the 2Q Tankan survey for **Japan** showing substantial declines, notwithstanding the fact that Japan has actually had a relatively good pandemic (so far). The headline index of large manufacturing firms dropped to -34 from -8. That's not as bad as the -58 Global financial crisis nadir, but is nonetheless, very bad. Large non-manufacturers dropped from +8 to -17 which compares to the GFC low of -31. The wealth of other material contained in the Tankan is too extensive to detail here, but here is a link to the English versions of the BoJ's report. My summary of this is that it shows a far bigger dent to demand than to supply, with the outlook for prices deteriorating further as a result.

Perplexingly, the outlook for business investment didn't look too bad. Whether this is an artefact of the stimulus measures, or something else, is hard to say. These numbers tend to be "guessed" at the beginning of each year, and then gradually adjusted in the right direction as the year progresses. So we may simply be watching that revision process at work.

South Korean export data for June has also been released, which was a little softer than the consensus expectation, though only just. Exports were 10.7% lower than a year ago in June, and imports 11.4% weaker. The net result of this was still a massive USD$3666m trade surplus, so nothing to get too upset about. And the direction of both exports and imports is improving, which is the main thing.

Even more data

The rest of the day offers even more data to get your teeth into:

From the **G-7,** the **US** offers us the June ADP result ahead of Thursday's (yes early this month) payrolls and labour report. We also have the Manufacturing ISM and Markit PMI figures released.

As far as the rest of the region goes: Prakash Sakpal notes the following somewhat downbeat backdrop for Thailand:

"Thailand: The government extended its state of emergency to end-July, the third extension since the decree came into force in late March. The Bank of Thailand's monthly report for May portrayed a continuing weak state of the economy. Weak domestic demand reflected from by steadily falling private consumption and investment indexes outweighed export and tourism weakness and the current account reversed to a surplus of $64 million in May from $654 million deficit in April. And, the THB ended June at the top of the EM performance table with 2.9% appreciation, sustaining worries of strong currency potentially hindering export and tourism recovery".

And in the **Philippines**, Nicky Mapa noted this morning that the general community quarantine in Metro Manila would remain in force for a further 15 days as daily new cases remained high and there was also further spreading in other regions. This will likely weigh further on the economic outlook. See also our ASEAN Bytes this morning.

So the picture of Covid-19 not being fully under control and the economies struggling to re-open quickly or fully is far from being only a US story, and it seems to be gaining more traction as we move out of 1H20 and into the second half. It wasn't supposed to be like this, but the pressure to re-open and re-invigorate economies seems to be too much for some to bear, and further mistakes are likely, which in the end will do economies far more harm than good. We aren't very good at learning from others in this pandemic. This has been a key feature right from the beginning.

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ASEAN Morning Bytes

Caution likely to dominate trading ahead of key manufacturing data on Wednesday

FOMC minutes and US manufacturing to give additional direction to trading

- **General Asia:** Covid-19 infections continue to accelerate in the US with some states reversing key lockdown measures, dousing hopes for a quick economic recovery as the virus spreads. Consumer confidence out from the US bested market expectation but the pickup in new daily infections may complicate the reopening of businesses. Regional PMI manufacturing reports showed a bounce in most of ASEAN mirroring the improvement in China's numbers a day earlier. Later on Wednesday, the US ADP jobs numbers and FOMC minutes will be released to give additional colour to trading.
- **Thailand:** The government extended its state of emergency to end-July, the third extension since the decree came into force in late March. The Bank of Thailand's monthly report for May portrayed a continuing weak state of the economy. Weak domestic demand, reflected by steadily falling private consumption and investment indices outweighed export and tourism weakness and the current account reversed to a surplus of $64 million in May from the $654 million deficit in April. The THB ended June at the top of the EM performance table with 2.9% appreciation, sustaining worries that the strong currency could hinder exports and any tourism recovery.
- **Philippines:** President Duterte extended partial lockdown measures in the capital region for

another 15 days with the Philippines experiencing a recent pickup in new daily infections. More worrisome would be the increase in new infections in provinces with infected workers returning home after strict hard lockdown measures were relaxed on 1 June. Despite the pickup in cases, department of finance secretary Dominguez and the rest of the virus task force continue to push for the removal of partial lockdown measures to get the economy back on track as the growth outlook dims. With the virus spreading across the country, we expect localized lockdowns to be implemented in hotspots which would derail the government's reopening plans and delay the economic recovery.
- **Indonesia:** Indonesia reports inflation for June with analysts expecting it to slip below 2% given subdued energy prices and depressed demand. Bank Indonesia (BI) expects inflation to remain benign for the balance of the year as the central bank focuses on maintaining IDR stability while also providing support to the national government to help spur the economy. We expect BI to trim policy rates in 3Q20 to help stimulate growth with the central bank timing such a move when IDR is relatively stable.

What to look out for: regional PMI and Covid-19 developments

- regional manufacturing PMI (1 July)
- Indonesia inflation (1 July)
- US ADP employment, ISM manufacturing PMI (1 July)
- US trade, non-farm payrolls, factory orders, durable goods orders (2 July)
- China Caixin PMI (3 July)
- Thailand inflation (3 July)
- Malaysia trade (3 July)
- Singapore retail sales (3 July)

China: PMIs surprise

Both manufacturing and non-manufacturing PMIs send a positive signal for the economy. Can it be sustained?

Source: Shutterstock

Passengers cheer up for Wuhan while waiting to take train K81 at Wuchang Railway Station in Wuhan, central China's Hubei Province, late April 7, 2020.

PMIs surprise on the upside

China's headline manufacturing PMI grew to 50.9 in June from 50.6 in May, and the non-manufacturing PMI increased to 54.4 in June from 53.6 the previous month.

Manufacturing diverges on domestic vs foreign orders

Demand for materials and products for the development of advanced technology, the real estate market and infrastructure projects support growing manufacturing activity.

The foreign orders PMI at 42.6 in June confirms that external demand remains weak. We believe that the ongoing Covid-19 situation in the US and Europe will keep the pressure on export orders in the coming months. External demand weakness is putting pressure on some manufacturers, especially small factories, of which the sub-index PMI fell to 48.9 in June from 50.8 a month ago. This confirms our view that small manufacturers continue to struggle to get export orders.

Service sector PMIs show the same domestic vs foreign divergence

Most of the service industries that showed a positive PMI in June were domestic-related, e.g. storage, delivery, information technology, financial services. But new export orders for services continued to be in contraction.

Covid-19 global infection will continue to hurt China

The divergence of the domestic recovery and foreign orders contraction highlights that the Chinese economy remains affected by the global situation for the Covid-19 pandemic.

As new infection cases globally continue to grow, we believe that China will continue to face a contraction in export orders in the coming months.

China Quarterly Update: Technology v bricks and mortar

Lockdowns and social distancing measures are short-term issues for the Chinese economy as a result of the Covid-19 pandemic, but solutions for the...

Covid-19's impact on the Chinese economy

The Covid-19 health pandemic has had at least two major effects on the Chinese economy:

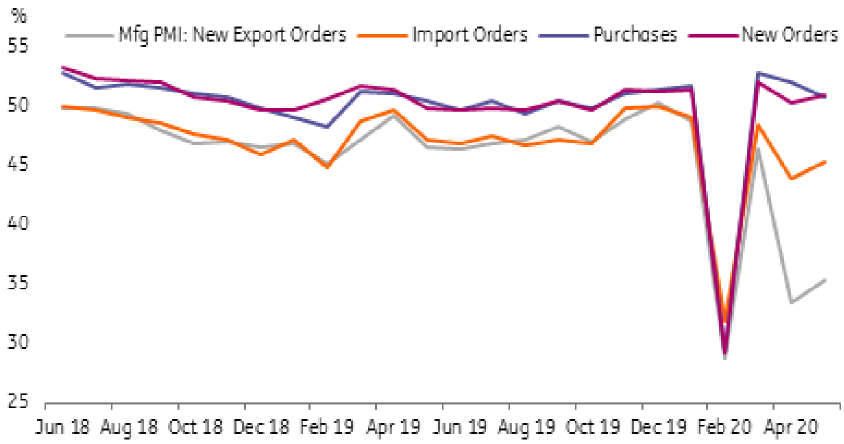
- External demand has been weak, and is likely to continue to be so, as a result of Covid-19 lockdown and social distancing measures, and therefore impacting China's export orders and hurting manufacturing and export businesses.
- Domestic demand in terms of retail sales has been subdued due to social distancing measures.

Covid-19 also makes the US-China 'phase-one' trade agreement less promising. Though China and the US seem to have agreed to uphold the agreement, there are risks that China may import fewer agricultural products from the US.

China will now require food importers to declare that agricultural products have not been contaminated by Covid-19 and this might prompt America to accuse China of not following through on the agreement quickly enough. China has argued that the slow progress is a result of

Covid-19.

China's manufacturing PMI breakdown



Source: CEIC, ING

Another important imminent risk: The technology war

Apart from Covid-19, more Chinese technology firms have been included in the US 'unreliable entity list' in 1H20, which restricts US companies from selling products and services to Chinese tech firms. Some western countries have joined the US banning specific Chinese tech companies, especially if the technology is 5G infrastructure and smartphone-related. It means Chinese technology companies will experience deteriorating sales to foreign companies.

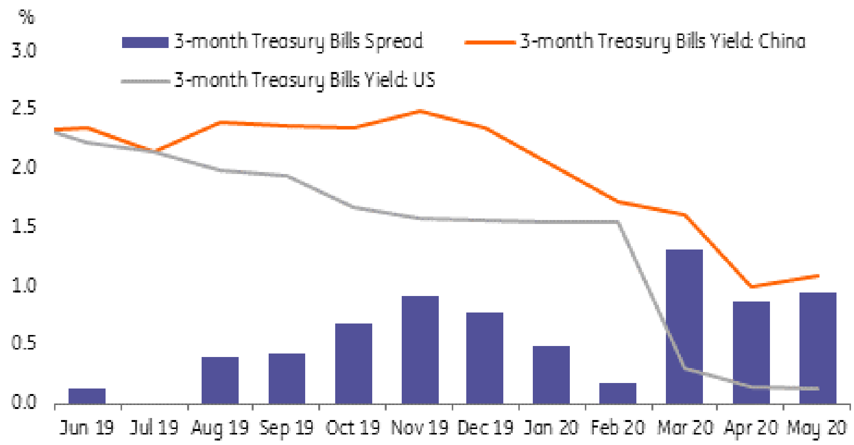
In the longer term, it means fewer technological exchanges between China and more advanced economies. China has decided to dedicate more resources to advanced technology research and development so that it can be self-reliant going forward.

Positive structural factors

- China's new foreign investment law, which in principle means that foreign companies will receive the same treatment as their Chinese counterparts, has come into effect since 1 January 2020.
- To move towards a technologically advanced economy, the government has set a scheme of “new infra”, which contains 5G infrastructure, Artificial Intelligence, Industrial Internet of Things (IIoT), big data centres, ultra-high voltage connectors, and high-speed rails. China has also built its own 'unreliable entity list' that can block out foreign companies from doing business with domestic firms. But at the time of writing this report, the unreliable entity list has not yet been triggered.
- Massive capital outflows aren't a big concern. China's capital account is not completely open, which is why there are no substantial capital outflows. Even if there was a demand for fund outflows, there are very few channels to do this. On the other hand, the cross border fund regulator (SAFE) has introduced policies that welcome more capital inflows in 2020, e.g. the quota system for foreign asset investments in China has changed to a post-investment registration system, which means there is no limit of inflows into China. Moreover, the sovereign yield spread between China and the US has been positive, which has been an attractive factor for multinational companies operating in China.

- Interest rate liberalisation in progress. The People's Bank of China has created the loan prime rate to replace the benchmark lending rate. But there is still a long way to go to reform the whole process so that the central bank relies on only one short term interest rate as its policy rate. Before the interest rate liberalisation process is complete, the CNY exchange rate cannot be expected to be free-float.

China-US sovereign bond yield spread



Source: CEIC, ING

Negative structural factors

- China's fiscal position continues to deteriorate. Government debt per GDP increased to 54% in 2019 from 49%. This amount excludes debt of local government special bonds, which is categorised as corporate bonds by its credit nature of no guarantee from the local governments. Bricks and mortar infrastructure projects are mostly funded by the issuance of local government special bonds. If the debt of local government special bonds is included then government debt per GDP rises to 102% in 2019 from 88% in 2018, and is expected to rise to 110% in 2020.
- Led by the US, the western world is increasingly reluctant to let China become a technology giant. It is likely that China will continue to build its own technical capacity. But in the meantime, there could be a shortage of advanced semiconductor chips, which dampens Chinese technology product competitiveness.
- An ageing population is a real problem for China. The government is addressing this by moving more residents from rural to urban areas, but the progress is slow.

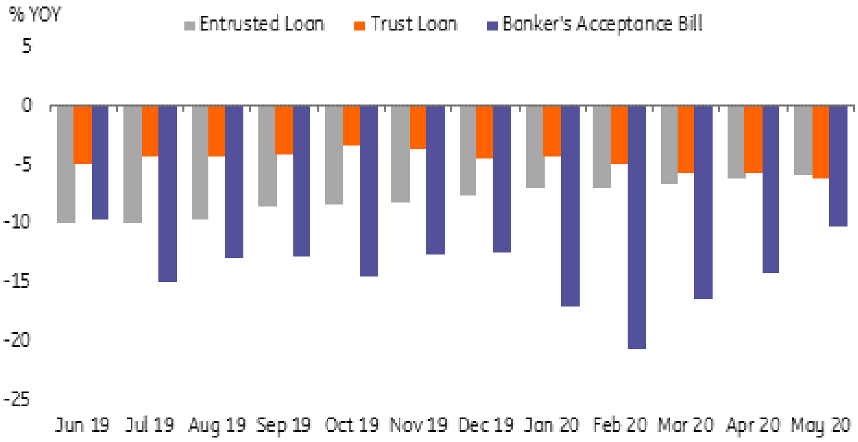
Policies to fight against the downward cycle

- Fiscal deficit as a percent of GDP is set by the 'Two Sessions' at over 3.6%. This is a flexible target compared to market estimates of 8% to 11%. The momentum of infrastructure stimulus seems to be slower than expected, particularly transportation infrastructure, which is one of the "new infra" projects. This could be a result of social distancing measures.
- Monetary policies can only supplement fiscal stimulus to help the economy recovery from Covid-19. As such, the central bank has adopted a targeted approach for SMEs and broad-based easing should be limited only.
- The silver lining is that we have not seen shadow banking activities make a comeback when

there is a big need for credit growth to support infrastructure.

- There have been no signs that the PBoC has used the depreciation of the yuan to boost exports as the reason behind dismal exports is very weak global demand. A slight depreciation of the yuan can't help exporters to get orders from foreign buyers. USD/CNY continues to move in tandem with the dollar index, and from time to time reacts to market news related to global Covid-19 cases, the technology war and the trade war.

Shadow banking continues to shrink despite the need of credit to support infrastructure



Source: CEIC, ING

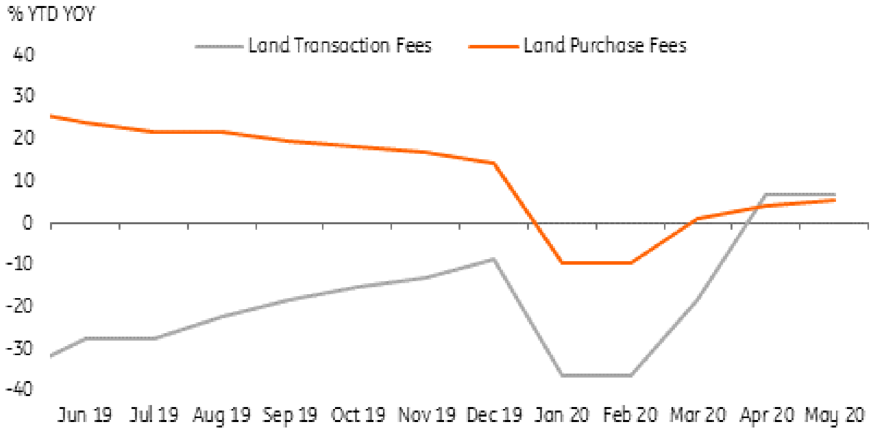
Loan growth has been fast but may be not as effective

Chinese loan growth has continued rising in the first five months of 2020 at 11.06%YoY compared to 9.49% in 2019 to support economic growth.

However, loan growth does not always translate into economic growth. It seems that some loans have entered into asset markets, including some real estate projects (as land sales fees have increased), stock and bond markets, and structured deposits. The rest has gone to infrastructure projects even when progress has been slow. Ample liquidity will keep interest rates low. 3-month SHIBOR has fallen continuously to 1.453% per annum at the end of May 2020 from 3.02% at the end of 2019.

The central bank has invented an innovative re-lending program for SMEs. At the end of May, Chinese banks have offered relief on CNY3.9 trillion of loans since the outbreak of Covid-19 to SMEs. More, banks have postponed taking principal repayments on CNY 1.44 trillion in loans to almost 800,000 SMEs and pushed back CNY 65.4 billion in interest payments. Banks also rolled over CNY2.4 trillion in financing to SMEs according to Bloomberg citing CBIRC officials. As such bank margins are expected to be squeezed in 2020.

Land fees increase during Covid-19



Source: CEIC, ING

Forecasts

GDP forecast

- Policies in 2020 are likely to focus on rebuilding the economy, which include structural policies, e.g. the "new infra" scheme and cyclical policy of fiscal stimulus. But the high uncertainty brought by Covid-19, e.g. whether there could be a second wave of infection, locally and globally, has made the government decided not to set any GDP growth target for 2020. This decision was reached after GDP growth in 1Q20 was -6.8% after +6.0% in 4Q19.
- The PBoC applies a targeted approach for liquidity injection, but monetary policies can only help the economy to a limited extent. When small businesses have difficulty surviving due to loss of foreign orders, which could be longer than previously expected if social distancing measures continue globally.
- We maintain our forecasts for the Chinese economy at -1.5% in 2020.

Interest rate forecast

- The PBoC is expected to continue its targeted easing approach. There should be more SME loans. This means broad-based easing is increasingly less likely.
- We expect there could be one more targeted RRR cut of 0.5 percentage points but unlikely to have an interest rate cut unless Covid-19 cases increase quickly and become difficult to be under control in China.

USD/CNY forecast

- The PBoC has shown no preference for a weaker yuan even during bad times like this. The yuan has strengthened against the dollar in Mayas Covid-19 cases subside globally.
- We expect USD/CNY will continue to move with global Covid-19 trends, the technology and the trade war, which means volatility can be high.
- Our forecasts for USD/CNY remains unchanged at 7.05 by the end of 2020.

Forecast table

	2019					2020				
China	**1Q**	**2Q**	**3Q**	**4Q**	**FY**	**1Q**	**2Q**	**3Q**	**4Q**	**FY**
GDP (% YoY)	6.4	6.2	6.0	6.0	**6.2**	-6.8	-3.1	-0.5	4.5	**-1.5**
CPI headline (% YoY)	1.8	2.6	2.9	4.3	**2.9**	5.0	2.6	2.2	1.9	**2.9**
PBOC 7-day reverse repo rate (% eop)	2.55	2.55	2.55	2.50	**2.50**	2.2	2.2	2.2	2.2	**2.2**
3M Shibor (% eop)	2.80	2.95	2.73	3.05	**3.05**	1.90	2.00	1.90	1.80	**1.80**
10-year T-bond yield (% eop)	3.07	3.20	3.14	3.10	**3.10**	2.60	2.90	2.95	3.00	**3.00**
Exchange rate (CNY per USD eop)	6.74	6.90	7.15	7.00	**7.00**	7.08	7.07	7.06	7.05	**7.05**

Source: ING