

Good MornING Asia - 1 October 2019

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In this bundle



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Source: Shutterstock

End in sight?

It would be nice to say that the looming talks between the US and Chinese trade negotiators ushered an end to the trade war - that would be a fitting birthday present to mark the 70th anniversary of the PRC. President Xi will deliver a speech today to mark this event, according to my Bloomberg's sources. And many will be listening hard to see if there is any hint that China is willing to strike a deal with the US.

This is important. For much of this trade war, we have listened to pundits describe this dispute as if it were something only the US could decide. In recent months, it has become clear that this is not just about China passively responding to US demands, but that China actively wants outcomes from a negotiated settlement too. Removal of tariffs is one of those requirements, as too is fair treatment for Huawei and other tech firms on the US entity list.

The US demand for greater protection against intellectual property theft is perfectly reasonable. But for public consumption, China's leaders will want to be seen to be changing its laws at its own pace and for their own merits, rather than being dictated to by the US. The same goes for any opening of market access, or changes to state-owned enterprise support.

Recent "olive branches" by both sides, more pork and soy buying by China, and a delay of the introduction of some tariff measures by the US, can easily be dissected as self-serving, and convey little about either sides' intentions. And the US is once again mixing optimism about progress in trade talks with unofficial threats that failure to make progress could make things much worse - rumoured ban on public listing, or of portfolio flows to China. I put this down to a negotiating tactic. And not necessarily something to be taken too seriously.

Our house view remains that a faltering US economy and faltering public support for the Trade war will eventually prompt President Trump to tread a softer line as the election race nears. But that, to some extent, does not fully take the China view into consideration. I'm not sure that the moment for a truce has yet arrived. And this is a view on which the risks are substantially skewed to the downside.

RBA - market says cut, I say, why?

Later today, the RBA meets to decide whether it needs to trim policy rates again following the June and July cuts. The market and consensus says "yes". I'm not so sure. I wrote this up at some length yesterday, and as this note has a vanishingly small shelf-life, [I thought I'd give it another plug here as the result is only hours away.](#)

Bottom line, the "hawkish cut" some are suggesting would be a massively wasted policy move when the limits to conventional policy are fast approaching. [See also our FX strategists take on what it means for the AUD](#) - even if I'm wrong, they are constructive.

Another argument for BoK rate cuts looming

The calendar today also has South Korean inflation. This has been soft for a long time and is a good excuse for the Bank of Korea (BoK) to ease policy rates further. But today, we will probably see the inflation rate actually turn negative, which is a bit more dramatic. Don't over-react to this though. Negative consumer price inflation is not the same as deflation, and most of it is a factor of food price spikes last year, not a reflection on the current economic weakness.

But there are enough reasons already for the BoK to ease again at its 16 October meeting. This inflation result may not be all that meaningful, but it doesn't help. Exports are already out for September, falling 11.7%YoY. Imports were down 5.6% and the trade surplus widened back out to \$5.973bn.

There is also inflation data due today from Thailand and Indonesia too - as well as Mfg PMIs for the whole region. China's PMIs yesterday were not too bad, though I'm not convinced these are reliable indicators for the region as a whole.

Consumption tax hike is here - so too is the Tankan

The much-speculated consumption tax hike in Japan has now arrived. The tax rate rises from 8% to 10%, and past increases have met with economic volatility, even recession. This one seems to have had far fewer impacts in terms of front-running of expenditures on everything from toilet rolls to houses, and this perhaps bodes better for the immediate aftermath, where a bigger drop-off may be avoided. That said, much of this data is still awaited, so things could still change on this front.

If things do deteriorate, at least the starting position is better than we were expecting. The latest Tankan survey registers a much less gloomy dip in business sentiment than had been predicted. The headline large manufacturing survey dropped from 7 to 5, not 1 as the consensus had forecast. And there were other misses on the optimistic side too for smaller firms and non-manufacturing entities.

For the next few months, the data from Japan will be dominated by consumption tax effects, which will make interpretation of any data flow extremely difficult. So this is about our last clear look at the economy until next year, when the fog may begin to clear.

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EM Space: Entering the final quarter of 2019

- **General Asia:** China begins the 70th Anniversary celebration today and local markets there are shuttered for the rest of the week. But there is plenty going on in the rest of Asia as a slew of September economic data will help to fine-tune estimates of the region's economic performance in the quarter just ended. What's in store for the region in the final quarter of 2019? The US-China trade war, the political crisis in the US, Brexit, and geopolitics – all tick the box to keep economic sentiment soured.
- **Indonesia:** September consumer price data is today with consensus looking for 3.5% YoY inflation, unchanged from August. Inflation has hovered near the mid-point of Bank Indonesia's 2.5-4.5% policy target. Barring supply shocks to food or oil prices, we don't see it becoming a policy risk anytime soon. And with growth overtaking currency stability as the key policy driver, BI's easing cycle still has room given the aggressive tightening in 2018.
- **Philippines:** The Bangko Sentral ng Pilipinas (BSP) forecasts inflation to slow to 0.6-1.4% in September (data due 4 October) as cheap rice imports flooded the market after caps on import quotas were lifted. Rice accounts for as much as 10% of the CPI basket and undoubtedly helped push headline inflation below BSP's 2-4% policy target. Given benign inflation, BSP has left the door open for further rate cuts in 2019 but we maintain our

expectation that they may be on hold for the remainder of the year.

- **Thailand:** We expect the September consumer price data due today to show a little-changed inflation rate than 0.5% in August. While the persistently low inflation sustains the case for more Bank of Thailand policy rate cuts, steady strong external payments support the Thai baht. Released yesterday, the current account posted a \$4 billion surplus in August, a sharp widening of surplus from \$1.8 billion in July. Even so, September ended on a weak note for the THB, suggesting that it's losing its luster as a good hedge in the current crisis.

What to look out for: US manufacturing and regional inflation

- Taiwan PMI manufacturing (1 Oct)
- Indonesia PMI manufacturing (1 Oct)
- US PMI manufacturing (1 Oct)
- Indonesia inflation (1 Oct)
- Thailand inflation (1 Oct)
- Hong Kong retail sales (2 Oct)
- US ADP jobs data (2 Oct)
- Singapore PMI manufacturing (3 Oct)
- US durable goods orders (3 Oct)
- Philippines inflation (4 Oct)
- Malaysia trade (4 Oct)
- US nonfarm payrolls (4 Oct)

Reserve Bank of Australia (RBA) - arguments for holding fire

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Its the unemployment rate stupid!

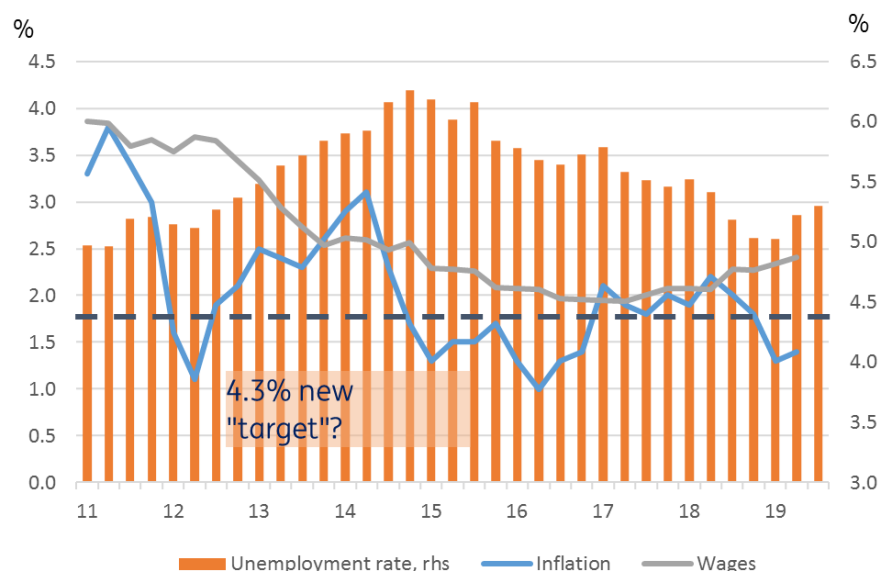
Perhaps the most damning piece of evidence against our own preference for a no-cut decision by the RBA this week was the latest labour market report. The key figure within this was a rise in the unemployment rate for August from 5.2% to 5.3%. The RBA themselves have noted that the unemployment rate would probably need to fall to closer to 4.3% to drive inflation higher. Inflation is currently 1.6%YoY, well short of its 2.5% mid-point target. So doesn't this seal the fate of this week's meeting?

The answer to this would be "yes", if the RBA really were just a mechanical, unthinking machine. You see, part of the problem with that sort of thinking is that to stimulate the economy sufficiently to drive the unemployment rate down to 4.3%, would probably mean cutting policy interest rates to zero, and then embarking on unorthodox monetary policy easing. Should the RBA cut rates next month too as the unemployment rate remains above 5.0%? And should it cut the following month too, and the one after that? The answer is very obviously no. Which brings us back to this month.

I think, and I believe the RBA is similarly persuaded, that monetary policy stimulus is not a linear

function of the policy rate, and indeed, that at low rates, its effectiveness is extremely limited. Indeed, there is a compelling argument for thinking that at low positive rates, and certainly for negative rates, Central bank "easing" actually does more harm than good. That is a very strong reason for not easing this month.

Unemployment rate, wages and inflation



Source: CEIC

A "good" rise in the unemployment rate

So easing further at today's already low rates (the policy interest rate is already only 1.0%) might not work, and could backfire. But is it even necessary?

Apart from the increase in the unemployment rate in August, the last labour report wasn't actually all that bad at all. Admittedly, of all the 34.7 thousand jobs created in August, 50.2 thousand of them were part-time, and the numbers of full-time jobs created actually fell by 15.5 thousand. But one of the things we have noticed and used to our advantage when forecasting these numbers is their "negative autocorrelation". In other words, bad follows good, and vice versa. Not only this, but part time and full time jobs themselves tend to be negatively correlated. Both of them tend not to rise or fall in the same month, so a rise in one tends to feed off the other.

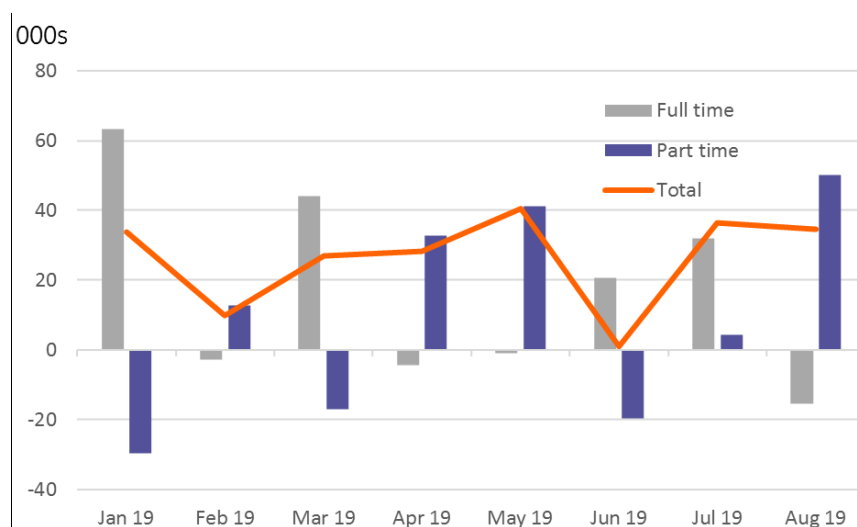
On this basis, the decline in full-time jobs in August was certainly due, following a solid 34.5 thousand increase the previous month. We will likely see these jobs rebound in the September report, though the numbers of part-time jobs will probably flop as a result, as some of these convert to full-time jobs. The overall numbers of employed will also probably grow at a slower rate or even decline in the September release, but for "good" reasons (full-time jobs will be rising).

As for the unemployment rate itself, this is always a fiddly figure for any economy, being made up of two very volatile components. The first part is the numbers of unemployed. In August, this rose a very modest 4 thousand. Not in itself much more than a rounding error, and much smaller than the numbers of jobs created in the same month.

The second part is the labour force, which refers to all those in work, plus those out of work but who are looking for work. This number swings around as marginal members of the labour force reassess the benefits of paid work against their prospects for actually getting work and drop in and out of the statistic.

Last month, the labour force grew by fractionally more than the numbers of jobs created, 38.8 thousand versus 34.7 thousand. That difference, entirely accounts for the rise in the numbers of unemployed. In other words, in net terms, no one lost their job in August, but more people started looking for work, which took them from economically inactive, to being part of the labour force, and for now, "unemployed".

Even then, the impact on the unemployment rate was tiny. To six decimal places, the unemployment rate rose from 5.238344% to 5.253583%, a difference of 0.015239 percentage points. In any language, this is insignificant, and a poor basis for any change in monetary policy.



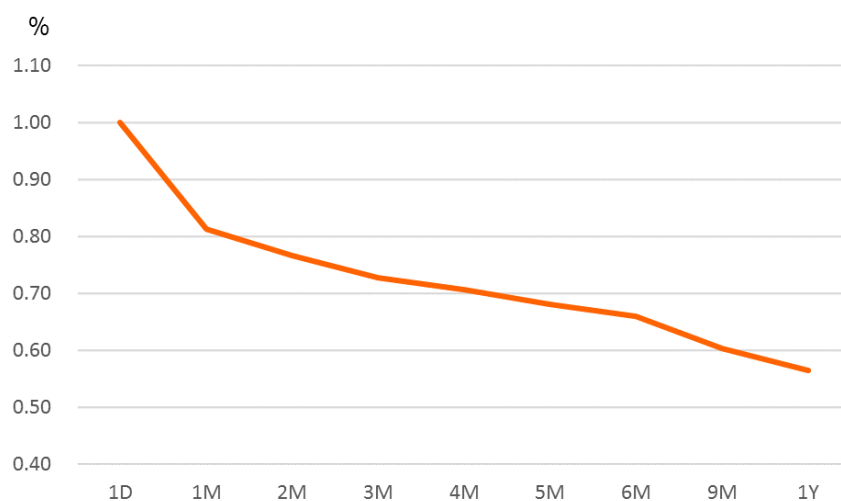
Source: Bloomberg

But wait, there's more - what about housing?

One of the biggest worries for households in Australia, after their employment prospects, was the value of their main asset - their home. With house prices falling for much of the last two years, the consumer had been fighting a very plucky rear-guard action to keep spending going in the face of balance sheet wealth declines and soft business investment.

Recent data from CoreLogic indicates that house prices are rising solidly again with gains in the important Sydney and Melbourne markets. Whilst no-one is seriously suggesting that the Australian housing market is becoming a bubble, it is equally hard to see it needing yet further stimulus as it recovers. Not surprisingly, many commentators from the residential real estate industry claim that this is exactly what it does need.

Australian implied policy rates from OIS curve



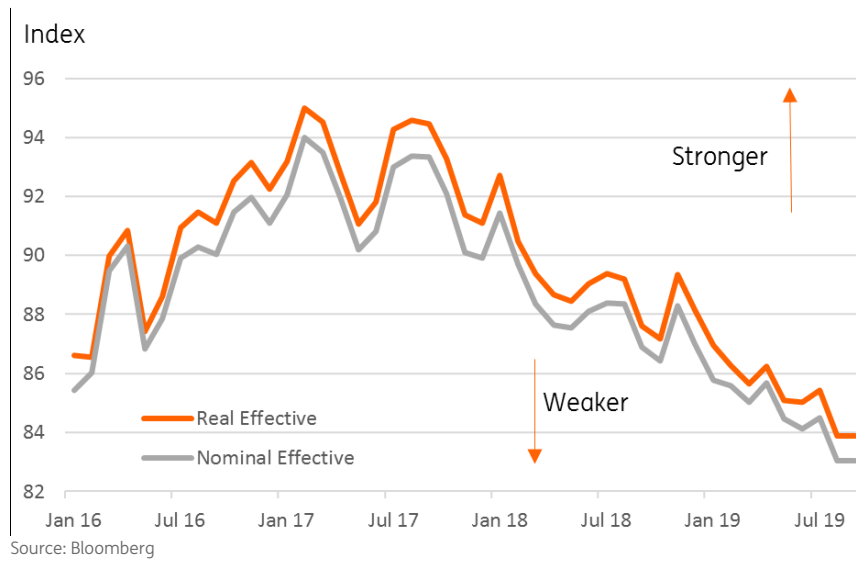
Source: Bloomberg

Economy at a "gentle turning point"

In a set-piece speech last week, RBA Governor Lowe did not give too much away. Sure, he noted the difficult external environment, and the easing being undertaken by other central banks which could yet play a part in his ultimate decision. But he also repeated three times that the Australian economy was at a "gentle turning point", suggesting he was not going to rush into further easing after the June and July rate cuts. And might still try to ride this one out.

Markets, as well as the consensus of economists, are braying for more easing. The OIS curve shows an implied probability of a rate cut this week at 80%. And failure by the RBA to deliver a cut at this week's meeting will likely see the AUD spike higher. But both real and nominal effective exchange rates for the AUD have weakened since the end of last year, and a small near-term spike should be quite manageable. If AUDUSD bounces back to a little over 0.68 following a no-change decision this week, then this would not derail Governor Lowe's "gentle turning point" for the Australian economy. It would also leave policy rates closer to a level at which, even if they aren't actually doing all that much good, they won't actually be doing any harm.

BIS - Australian effective Exchange rates



Author

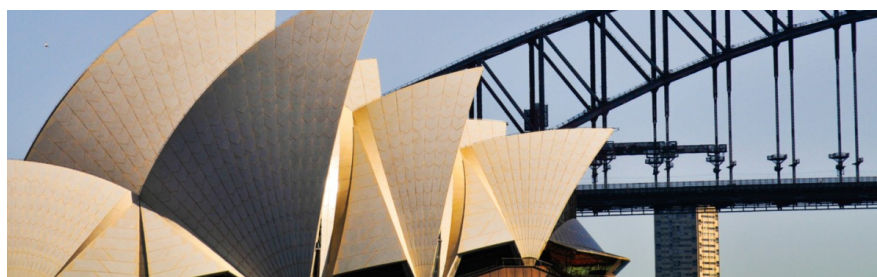
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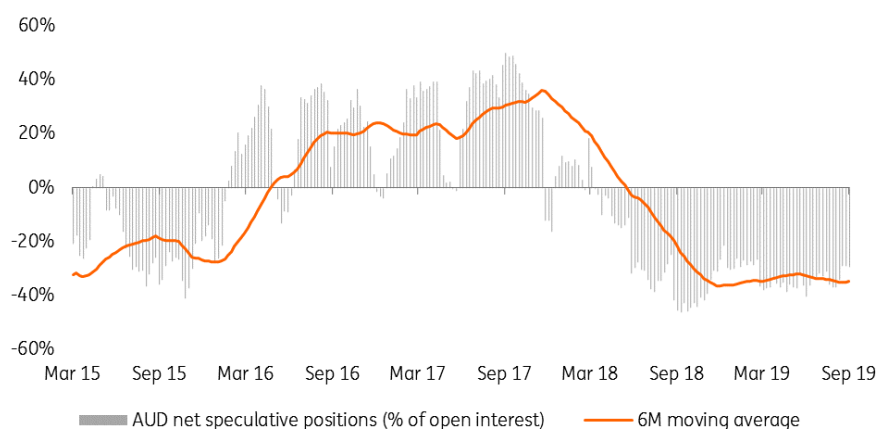
Rate cut may not be enough to dampen the Aussie dollar

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Speculative markets remain extensively short AUD

Latest CFTC positioning data shows that the market retains a bearish stance on the Australian dollar, with short contracts now reaching 29% of open interest.



Source: CFTC, Bloomberg, ING

This is likely explained by lingering global trade tensions, with the negative implications for Australia's China-dependent exports still clouding the economic outlook. The RBA has played a role in denting appetite for the AUD by eroding the rate advantage versus low-yielding safe havens, prompting investors to choose other "activity currencies", such as the Canadian dollar, to position for any rebound in global sentiment.

AUD rose in 24 hours around 7 of the last 8 RBA meetings

| Meeting date | Cut implied probability* | Decision | AUD TWI (24hr around announcement) |
|--------------|--------------------------|-----------|------------------------------------|
| 05-Feb | 6% | Unch. | 0.280% |
| 05-Mar | 1% | Unch. | -0.210% |
| 01-Apr | 3% | Unch. | 0.270% |
| 07-May | 45% | Unch. | 0.400% |
| 04-Jun | 100% | 25 bp cut | 0.110% |
| 02-Jul | 79% | 25 bp cut | 0.290% |
| 06-Aug | 9% | Unch. | 0.270% |
| 03-Sep | 12% | Unch. | 0.400% |
| 01-Oct | 80% | | |

Source: Bloomberg, ING

* Derived from the RBA Cash Rate futures one day before the meeting

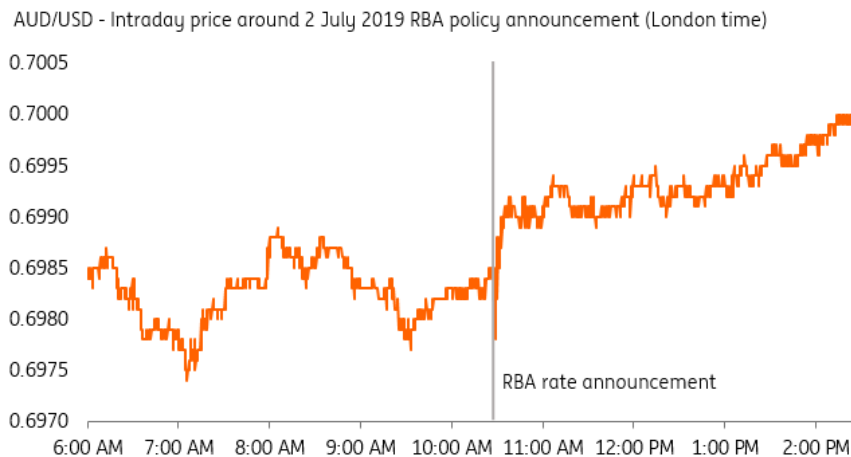
Pre-empting moves by other global central banks, the RBA cut interest rates in June and followed up with another 25 basis point reduction in July, taking the cash rate to a new record low of 1%. Arguably, this has contributed to the weakening of AUD/USD by approximately 4.20% year-to-date, although the deterioration in US-China trade relationships has likely played a bigger role in denting appetite for the currency.

However, the intraday performance of the Aussie dollar around the RBA meetings has been generally positive (looking at the changes in the AUD trade-weighted index in the 24 hours around the meeting). Focusing on the last two RBA cuts specifically, the easing move did not trigger AUD weakness.

Similarities with the July meeting

The RBA cash rate futures currently display an 80% implied probability of a 25 basis point cut tomorrow. This is approximately how much was priced in right before the 2 July rate cut.

And the analogies don't stop there. The data flow in September has been quite similar to that seen in June (right before the July policy announcement). In both instances, GDP numbers showed some resilience, matching estimates, while the unemployment rate came in higher than expected at 5.2% in May (report published mid-June) and 5.3% in August (report published mid-September).



Source: Bloomberg, ING

Forward-looking language will be key

Should the RBA go ahead and cut rates tomorrow (as the market expects), we could see the Aussie dollar respond as it did the last time the Bank cut rates. While market expectations for a cut in July were not unanimous, AUD/USD traded higher as markets quickly overlooked the rate cut and instead focused on the forward-looking language by Governor Philip Lowe, who failed to provide clear indications about more easing ahead.

[As noted by our economics team in the RBA meeting preview](#), there are a number of arguments in favour of keeping rates on hold. Should this be the case, AUD/USD would likely jump above the 0.68 level as rate expectations are scaled back. However, even in the case of a rate cut, there is a non-negligible risk that the forward-looking language will be (similar to July) less dovish than expected. This may erase the negative effect of the cut on AUD, with the possibility of replicating the July price action, ultimately averting any AUD downside on the day.

The market's stretched positioning also raises the risk of some short-covering, which suggests possible upside risk for the currency. All this leads us to conclude that the balance of risks for the AUD is skewed to the upside ahead of tomorrow's RBA policy meeting.

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