Good MornING Asia - 10 October 2018

Correlations between bond yields and equity prices are turning negative - could this be a sign of a looming market correction?

In this bundle

Opinion | 10 October 2018

Markets at a crossroads

Correlations between bond yields and equity prices are turning negative - could this be a sign of a looming market correction?

Source: Shutterstock

But first...EM inflection point reached?

As promised yesterday, here is a more detailed consideration of the excellent speaker comments at the recent EMTA meetings in Hong Kong and Singapore. My thanks to the panelists from both buy and sell-sides, and to the audiences who provided me with such rich information in terms of their market views.

Now, what about those markets?

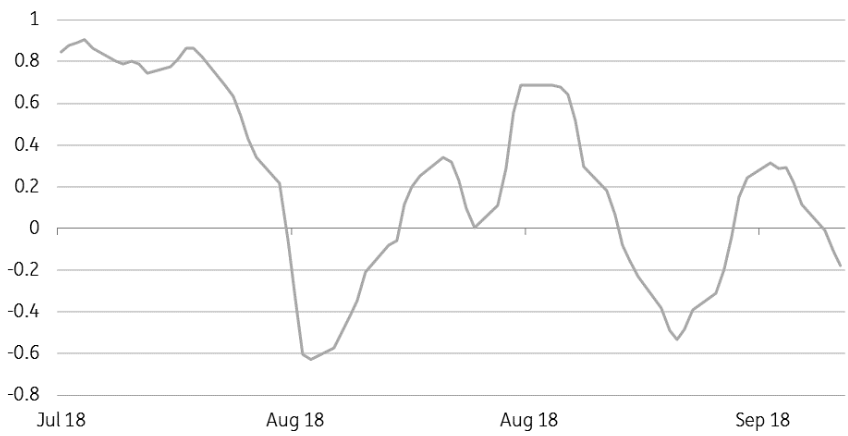
10Y US Treasury yields are little changed today, but US stocks have fallen further. In recent months, that pattern has not been observed. Instead, we have seen the usual, equities rise, bond yields rise, equities fall, bond yields fall. In other words, it has looked as if markets are being driven from the equity side. Bonds come along for the ride. Their increase in yield never really threatening the valuations of the equity markets.

To see if there is any possibility of that relationship changing, the chart below looks at the 10 business day change in 10Y US Treasury yields and tracks its 20-day correlation with the change in the S&P500 over the same period. Right now, it is slightly negative. In other words, equities can fall, and bond yields can still hold up, or put another way, a rise in bond yields can push equities down, and not simply be snuffed out in a circle of positive correlations, which drag bond yields back down again.

To be fair, this isn't particularly pronounced just yet, so it is premature to be calling the next big crash. But big crashes start life as small movements, so this is worth watching.

We've seen two similar periods of bond yield generated corrections in equities in recent times. The first the big November 2016 reversal in bond yields, which saw about an 80bp increase in yields. The more recent June 2017 move was only about 20bp, though quite sharp. On both occasions, the 20-day correlation between the 10-day change in bond yields and equities approached -1.0. Right now, the correlation is only -0.17. But if it gets to -0.5, things could look a bit more interesting.

20 day correlation of 10-day change in 10Y Treasury yield, S&P 500 price



Asia Day ahead

With G-7 equities on the slide, but bond yields holding up, the Asia market backdrop should be somewhat negative, though in currency space, it looks mixed rather than outright negative right now.

Japan released some very strong core machine orders data for August, building on the good July figures. Together with decent household spending figures, strong investment should deliver a robust 3Q8 GDP figure. Another reason for the BoJ to keep edging away from quantitative easing

Philippine August trade data is also due out later today. Consensus expectations are for little change to the July deficit of $3546m. The Peso has actually been performing remarkably well in recent days. Signs that markets may be getting more relaxed about the backdrop for EM, or potentially, a reward for past and expected policy action.

China could release money supply data today. If so, we would anticipate an increase in new yuan loans from last month.

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

Article | 9 October 2018

ASEAN Morning Bytes

General market tone: Risk-off Risk aversion remained the theme with Treasury yields remained elevated and global oil prices tiptoed higher on reports of...

International theme: Hawkish Fed, China slowdown drive weak market sentiment

- Risk-off scenario continued to pervade with concerns of a hawkish Fed coupled with a projected slowdown in China weighing on sentiment. Yields did manage to trip lower and US stocks bounced ever so slightly on bargain hunting but the sentiment remains frayed.

EM Space: Asian markets remain on the backfoot

- **General Asia:** Asian markets remained on the backfoot on Tuesday on still elevated Treasury bond yields and rising global oil prices. Asia looks to open mixed, wary of developments on Trade and the movement in oil prices. Fed Kaplan's support for further rate hikes will likely keep the pressure on yields to remain higher as the hawks grow in number at the FOMC.
- **ASEAN:** The IMF retained its 5.3% GDP forecast for 2018 but lowered its 2019 expectation to 5.2%, down 0.1 percentage point on expectations that economic activity may take a hit from the on-going US-China trade debacle.
- **Malaysia:** Bank Negara Malaysia's Governor Nor Shamsiah Yunus expressed confidence

about robust private sector activity continuing to support the economy into 2019 even as global trade tension weigh on exports. Separately, Prime Minister Mahathir said the government was considering new taxes and asset sales to make up for the revenue loss from scraping of the Goods and Services Tax and to repay its debt. The tighter fiscal policy stance will be a potential headwind for GDP growth. We see the BNM leaving the monetary policy on hold through 2019.

- **Thailand:** Deputy Prime Minister Somkid Jatusripitak sees the need of boosting local economic growth amid rising US-China trade spat, which he sees lasting for the next two-to-three years. He urged exporters and businesses to be prepared to offset the impact from the trade war. The THB seems to be coming in shadows of Asian underperformers INR and IDR. In a sudden reversal of fortune, the THB's 2.1% month-to-date depreciation appears to be excessive given a still large current surplus, which we estimate at about 7% of GDP this year.

- **Philippines:** President Duterte has allowed open access for imports of the all-important staple rice in a bid to tame stubborn inflation by allowing private traders to secure and import the grains granted that they settle the tariffs. Rice accounts for 9% of the CPI basket and controlling inflation of this important food item could help lower overall inflation and anchor inflation expectations in the coming months.
- **Philippines:** Trade numbers will be reported in the morning session which will likely point to a protracted widening of the deficit with imports expected to grow by double digits while exports continue to languish. The sustained widening of the trade gap, which in turn drives the current account deficit, will continue to put pressure on the local currency with the BSP seen digging into its reserves to limit excessive volatility in the spot market.

What to look out for: Fed speakers, IMF-WB meetings

- Fed Williams speaks (9 October)
- Fed Harker and Williams (10 October)
- PH trade balance (10 October)
- US Producer prices (10 October)
- Fed Evans and Bostic speak (11 October)
- US inflation (11 October)
- China trade balance (12 October)
- IMF-WB annual meeting in Bali (12-14 October)

Author

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Article | 9 October 2018 **FX | China | India...**

Have emerging markets reached an inflection point?

This was one of the many questions we asked the attendees of the Emerging Markets Traders Association meetings in Hong Kong and Singapore. Although there...

Source: istock

A poor outlook for emerging markets

The Emerging Markets Traders Association (EMTA) meetings in Singapore and Hong Kong took place against the backdrop of the escalating trade war, emerging market sell-off and contagion, Chinese central bank policy action and Indian central bank policy inaction this year.

The event was hosted by ING, and there was plenty to talk about, not least, where last year's panel went wrong. Last year the panel had agreed that although an inflection point for emerging markets was near, it wasn't imminent. Clearly, that inflection point has now been reached, so we asked whether it had further to go, or whether the more battered parts of emerging markets were starting to look good value?

> *The consensus was that EM still has a place, but needs careful differentiation - a blanket tracking approach was unlikely to*

deliver superior performance

There was some divergence in terms of the Singapore and the Hong Kong panel, with Singapore more open to the idea that EM assets were nearing (but hadn't yet reached) good value, but the Hong Kong panel was more reluctant to call a buying opportunity just yet.

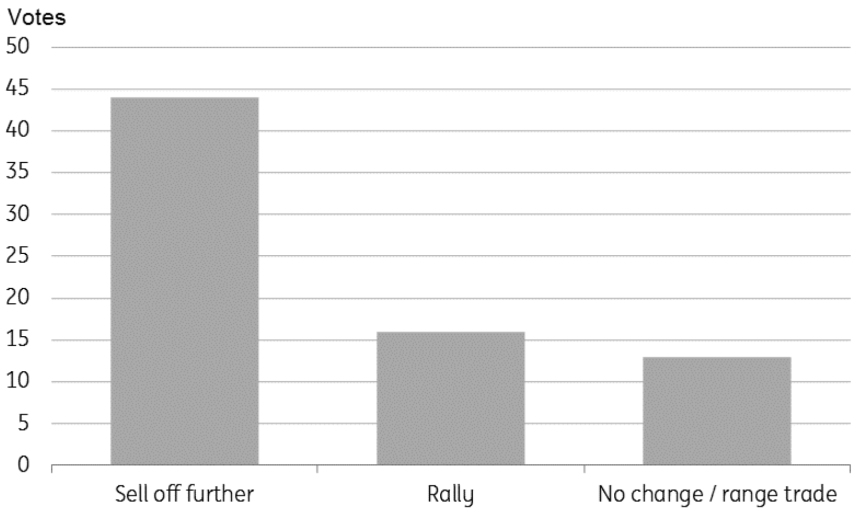
The panelists discussed whether there was a place for EM in portfolios, given that the S&P 500 had returned better returns for lower risk profiles since the Lehman crash. The consensus was that EM still has a place, but needs careful differentiation - a blanket tracking approach was unlikely to deliver superior performance. Another observation was that recent market weakness had reflected more a lack of buying, than any substantial fund outflows. This has been a somewhat orderly re-pricing rather than a wholesale rejection of the EM universe.

The biggest negative shock that could make for an even bleaker outlook would be an acceleration in US inflation, coupled with a slowdown in the US and/or Chinese growth

The audiences in both settings were still negative, with 38% more votes by the audience in Singapore for a further sell-off over the coming 12- months than for a rally (see chart below) and a 40% margin in Hong Kong favouring more selling.

The biggest negative shock that could make for an even bleaker outlook would be an acceleration in US inflation, coupled with a slowdown in the US and/or Chinese growth. That was seen as combining all the most negative components that would result in a much more aggressive EM sell-off, dashing hopes for a rally.

The market outlook for EM on a 12-month horizon



What's changed? The USD for one...

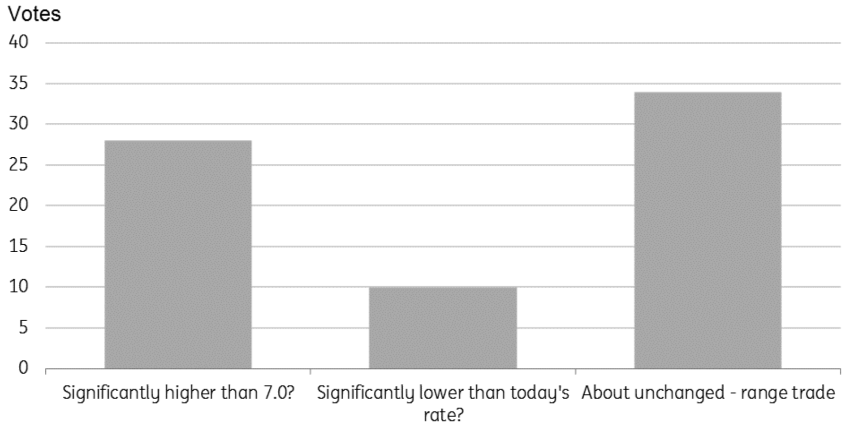
One of the main reasons for the worse emerging market outturn than expected by the panel last year was the appreciation of the US dollar. It was felt that this was mainly a function of the market capitulation to fall in line with the Fed dot diagram, and had been driven by recent Federal Reserve speaker comments, in particular, Jerome Powell and also the strength of recent US data flows. Whereas last year, there was maybe a sense of "Fed fatigue", which clearly has been shaken off.

Looking to the future, many panelists felt that the USD would weaken next year, though there was also a fairly uniform sense that the CNY would weaken further too, and in all likelihood, push through USD/CNY 7.0. All the panelists tended to argue that if USD/CNY did push through 7.0, it wouldn't be by so by much. A couple of panelists still had a low conviction feeling 7.0 would be held, mainly as to see further weakening raised problems of:

1. Limited effective depreciation as other regional currencies follow
2. Increased pressure for outflows
3. Currency manipulation concerns

Even the softer USD view was tempered with risks, including the uncertain outlook for Eurozone and the euro, given the Brexit uncertainty, the ongoing Italian budget saga and EU elections.

Where do you see USD/CNY in 12 months?



What else? Oil hasn't helped

Another factor worsening the outlook for externally challenged economies and especially those for whom inflation was already on the verge of being a problem, is the price of oil. According to panel members, this was definitely a contributing factor to the worsening positions of Indonesia, India and the Philippines.

One of the factors that had gone wrong was that the "safety valve" of shale gas from the US had failed to respond as it had previously, as pipeline capacity constraints had prevented oil getting from where it was drilled to where it was needed. Addressing these logistical issues would happen in time, but it might be well into 2019 before this starts to alleviate pressure.

So although there was a widespread sense that oil prices would moderate over the coming 12 months, there seemed to be little conviction this would happen imminently.

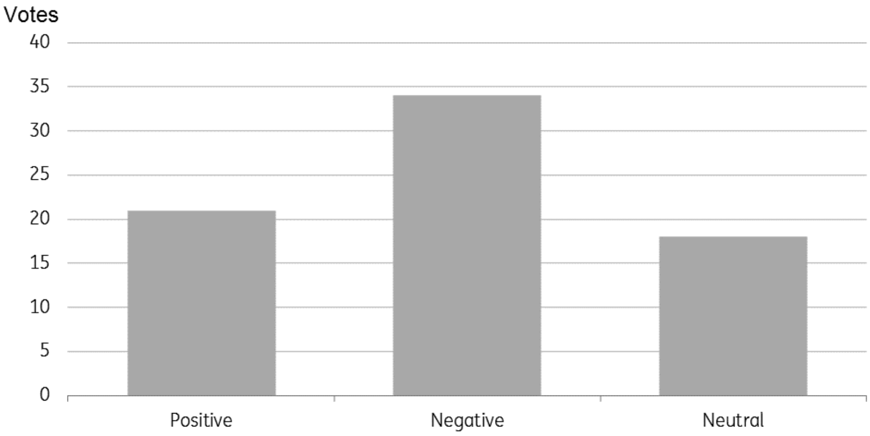
Some old favourites remain; think Indonesia

Panelists have for years cited Indonesia as one of their favourite markets. But in spite of market developments this year, they still see Indonesia as closing in on some value, and while they are not quite ready to take the plunge just yet, the Indonesian market is still viewed favourably.

Factors in Indonesia's favour aside from the fact that yields have risen and the rupiah has plunged include a positive and proactive central bank approach and ongoing infrastructure investment. Negatives include next year's Presidential elections.

The Singapore audience wasn't so positive, with a net negative to the positive outlook of about 18 percent.

What is the 12-month market outlook for Indonesia?



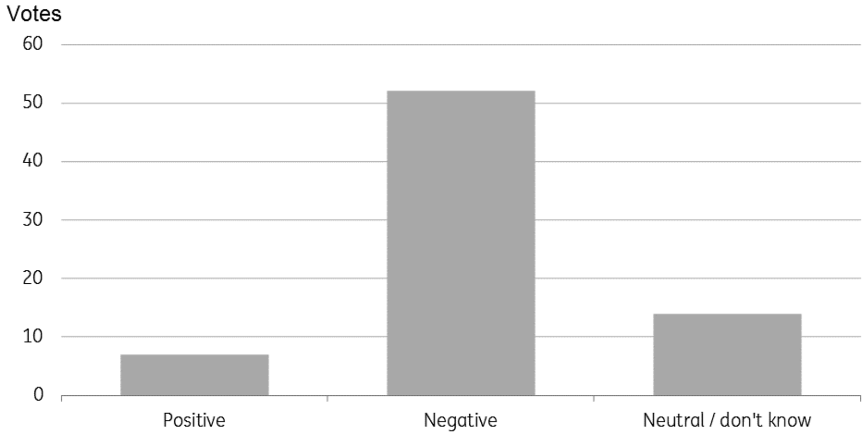
Others...not so much

However, India didn't get such a glowing review, and was definitely off the favourites list this year and firmly on the most disliked list. Foot-dragging by the Reserve Bank of India in the face of the rupee's plunge and likely imminent reversal of currently favourable inflation prints, plus some unimpressive market restrictions to curb the external deficit has led to this change of view.

One panelist drew similarities between the RBI's recent policy inaction and that of the Sri Lankan central bank, though to be fair, in Sri Lanka's case, the growth outlook was admittedly much weaker, making their inaction somewhat more understandable. One panelist referred to the Sri Lankan situation as toxic, referring to the additional complication of elections in 2020.

The audience in Singapore had an even more unfavourable view of India relative to Indonesia, with a net negative to a positive spread of almost 62%.

What is the 12-month market outlook for India?



Trade - getting worse

With worsening US-China trade relations at the back of many investors' minds, we also asked the audience whether they saw a resolution to the trade war within a 12-month window. The vast majority, by more than 34%, thought that it would get worse, rather than better.

Some panelists felt that US trade protectionism could actually intensify after a poor mid-term result for President Trump

One highly interesting observation by panelists was that the previous received wisdom that a poor Republican mid-term election result would lead to some pull back on the trade aggression no longer held. Recent comments by Vice President Mike Pence, the microchip scandal, election meddling allegations and a naval 'game of chicken' seemed to have taken the trade dispute to new and much more hostile levels. Few could see a positive scenario emerging and some felt that US trade protectionism could actually intensify after a poor mid-term result for President Trump.

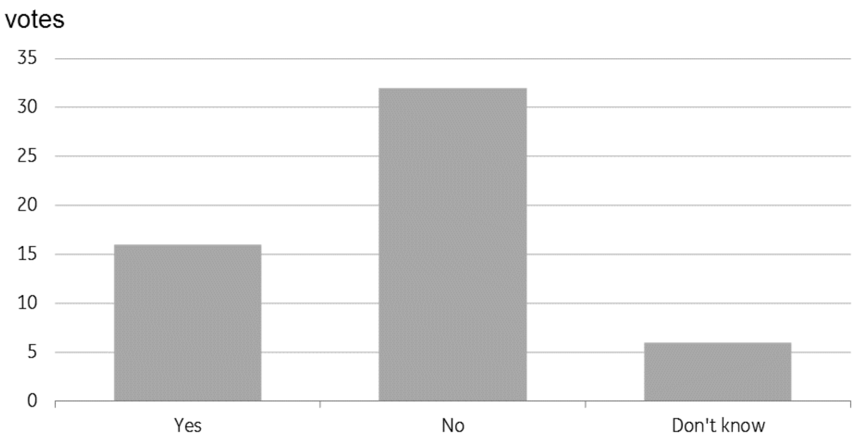
The trade war is unlikely to deliver any absolute benefits to economies in the Asia region, some thought that the relative winners of this trade war would be Vietnam, Malaysia and Thailand

Another interesting remark was that any future change in the US executive would not necessarily result in a reversal of the trade aggression. One panelist indicated that this policy was winning support from supporters of both parties, with the main bone of contention being the approach taken, rather than the goal. The goal is to reduce non-trade barriers and eliminate coerced technology transfer. Losing the tariff revenue was likely to be a bitter pill to swallow for any future President of either party looking to overturn current trade policy shifts.

Although the trade wars were not likely to deliver any absolute benefits to economies in the Asia region, panelists thought that the relative winners of this trade war (in order of their relative gains), would be Vietnam, Malaysia and Thailand.

Do you see a resolution to the US-China trade war

(12-month horizon)



Likes and dislikes

In both Singapore and Hong Kong, market favourites included:

- Thailand
- Vietnam
- Malaysia
- Indonesia (still and with reservations)
- Singapore

Making it onto the disliked list were:

- India
- Sri Lanka

And the two with mixed sentiments were:

- Korea, but some panelists felt the Bank of Korea's threats to hike in response to household debt were counterproductive, though this wasn't a unanimous view.
- China (in the thick of the trade war, but with considerable government and central bank support.

Author

Robert Carnell
Regional Head of Research, Asia-Pacific
robert.carnell@asia.ing.com

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