

Good MornING Asia - 11 May 2018

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Asia week ahead: How will Malaysian markets react to a political shift?

Politics may overshadow economics and markets in Malaysia and India, while hopes rise of a breakthrough in the second round of Sino-US trade talks



➔ Malaysia – Are markets caught off guard?

Sentiment in Malaysian markets next week will be driven by the surprise outcome of the general election held on Wednesday, 9 May ([see “Malaysia: Mahathir returns, uncertainty lingers” for more](#)). Due to a public holiday on the remaining days of this week, investors had no chance to react and have been forced to wait until markets re-open on Monday, May 14. We anticipate the knee-jerk reaction to be more negative than positive, as investors had been pricing in continuity of previous government policy, and the unexpected voter verdict has caught them off guard.

The Malaysian currency (MYR) has lost 2.2% against the US dollar since early April. We expect weakness to continue until the political dust settles. Meanwhile, Malaysia's GDP and balance of payments data for the first quarter (due Thursday, 17 May) is expected to reveal that the economy continued to perform well coming into 2018. We forecast steady, strong GDP growth of 5.6% year-on-year in 1Q18. But for now, nothing matters more than politics.

5.6%

ING forecast for Malaysia GDP growth in 1Q18

Year-on-year

➔ China – Will second round trade talks with US see breakthrough?

A Chinese delegation led by Vice Premier Liu He will visit the US for another round of trade talks, after a stalemate in the previous round a week ago. With both sides remaining firm on their stance, any breakthrough may appear to be a less probable proposition. What's good for the markets, for now, is that at least they are coming to the table to talk it through. However, the Xi-Trump phone conversation this week on a possible consensus to resolve the issue is keeping hopes high for the upcoming talks.

Chinese data on the calendar in the coming week are industrial production, fixed asset investment, retail sales and housing market data for April. We forecast a modest pick-up in economic activity growth. Absent a significant trade shock, the Chinese economy will continue to grow steadily this year.

➔ India – What's in store for Modi's BJP in Karnataka?

Assembly elections in the southern state of Karnataka are held on Saturday, 12 May. Prime Minister Modi's Bhartiya Janata Party (BJP) will take on ruling Indian National Congress (INC) for the 224 assembly seats. The outcome of this and other state elections later in the year will be an important guide to whether the BJP retains power at the national level in the general elections to be held in mid-2019.

Although politics is capable of nudging the focus away from economics, the key economic data on inflation trade is unlikely to go unnoticed in an ongoing selloff in local financial markets. Our forecasts look for an acceleration in consumer price inflation and the wider trade deficit in April, suggesting there will be no respite from the weak market sentiment.

➔ Indonesia – Will central bank move to tightening?

Indonesia's central bank (Bank Indonesia) announces its monetary policy decision on Thursday, 17 May. We aren't forecasting a hike at this meeting but will not be surprised if BI delivers one, which is required to stem a selloff in the Indonesian rupiah (IDR) and the sovereign debt. Inflation has been anchored within BI's 2.5-4.5% policy target but a weak currency and rising global oil prices have increased the chances of it accelerating above target. We do not think one rate hike will be enough and have pencilled in one more towards the end of the year.

4.25%

BI policy rate

Asia Economic Calendar

Country	Time	Data/event	ING	Survey	Prev.
Friday 11 May					
India	1300	Mar Industrial production (YoY%)	5.6	5.7	7.1
Singapore	0600	Mar Retail sales value (MoM/YoY%)	-0.9/1.5	0.8/1.5	-1.7/8.6
Monday 14 May					
India	0730	Apr WPI (YoY%)	3.5	2.83	2.47
	1300	Apr CPI (YoY%)	4.9	4.4	4.28
Tuesday 15 May					
China	0300	Apr Retail Sales (YoY%)	10	10	10.1
	0300	Apr Industrial Production (YoY%)	6.3	6.4	6
	0300	Apr Fixed asset investment (YTD, YoY%)	7.7	7.4	7.5
India	-	Apr Trade deficit (US\$bn)	-14500	-15200	-13692
	-	Apr Exports (YoY%)	5.5	-	-0.66
	-	Apr Imports (YoY%)	7	-	7.15
Indonesia	0500	Apr Imports (YoY%)	11.2	-	9.07
	0500	Apr Exports (YoY%)	7.8	-	6.14
	0500	Apr Trade balance (US\$m)	1025	-	1091.7
Philippines	-	Mar OCW remittances (YoY%)	4	-	4.5
Wednesday 16 May					
Thailand	0805	Benchmark Interest Rate	1.5	-	1.5
South Korea	0000	Apr Unemployment rate (% SA)	-	-	4
Thursday 17 May					
Malaysia	0500	1Q GDP (SA QoQ/YoY%)	1.6/5.6	-/-	0.9/5.9
	0500	1Q Current account (Q) (MYR bn)	9800	-	12900
Indonesia	-	May 17 BI policy decision (7-day rev. repo %)	4.25	-	4.25
Singapore	0130	Apr Non-oil domestic exports (MoM/YoY%)	-/-	-/-	-1.8/-2.7
Friday 18 May					
Singapore	-	1Q F GDP (Q) (YoY%)	-	-	4.3
	-	1Q F GDP (QoQ Annualised%)	-	-	1.4

Source: ING, Bloomberg

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China: overcapacity reform continues to push up PPI inflation

In the coming months, overcapacity reform in cement and glass could continue to push up these material prices. Potential tariffs have yet to affect inflation. Mild inflation numbers will allow the central bank to focus on financial deleveraging reform. We expect the PBoC to follow most of the Fed's rate hikes this year but only by 5 basis points each time



Source: Shutterstock

Overcapacity reform keeps driving up material prices

Headline PPI rose 3.4% YoY in April, up from 3.1% in March.

The main increase was in the category of building materials and non-metals (10.7% YoY), which in our view are cement and glass.

These two materials are the key reform sectors of this year's overcapacity cut plan. It would indeed not be surprising if this increase in the price trend of building materials would continue for the rest of the year.

Potential tariffs from the US have yet to be reflected in PPI, though if the tariffs are implemented then it would push up PPI. But the tariffs would not be fully reflected in metal prices as there would

be substitutes of imports from other locations.

CPI inflation was milder but we see more volatility from food prices from the coming adverse weather

Headline CPI inflation was 1.8% YoY in April, milder than the 2.1% in March.

Egg prices continued to go up (14.9% YoY) due to external demand for Mainland China's eggs as there was a large-scale egg recall by the US in April.

On the other hand, we note that there is an on-going increase in healthcare inflation (5.2% YoY), which has been broad-based from Chinese medicines and Western drugs to healthcare services. This could reflect that (1) the population requires more healthcare services as the population has started to age; and (2) the rise of the middle-income class is more aware of their healthiness and this has increased the demand for healthcare services.

In the coming months, we expect fruit and vegetable prices to be higher as the adverse weather season is about to start.

Mild CPI gives room for PBoC to exercise flexibility

Mild inflation is good for the central bank, as it frees up the PBoC to focus on reform.

Nowadays, the central bank is heavily engaged in handling financial deleveraging reform. There is already a case that a local government financial vehicle is defaulting on its debt. This is certainly the result of financial deleveraging. But the central bank would need to skillfully manage liquidity so that the case does not fuel a series of defaults, which would make the market nervous.

We expect the central bank will be able to manage the rising credit risks in China, which is a by-product of financial deleveraging.

Having said that, we still expect the central bank to follow the Fed for most of the rate hikes this year, but only by 5 basis points each time to reflect the already tightened liquidity conditions in China.

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Malaysia: Mahathir returns, uncertainty lingers

The lingering political and economic uncertainty ahead leads us to revise our end-2018 USD/MYR forecast to 4.05 from 3.84 previously



4.05

ING forecast of USD/MYR at end-2018

Revised up from 3.84

The best of MYR appreciation may be over

The markets were counting on the return of the former government of Najib Razak for continued economic and political stability. So, an initial negative market reaction to the surprising election results seems probable, though that will not be until Monday, 14 May when the market opens after the election holiday. But that's not all.

The lingering political and economic risks as we outline below will weigh on investor confidence and performance of local markets, especially the Malaysian ringgit (MYR) for some time, probably through the end of this year. The MYR has lost 2.2% of its value against the US dollar since early April. Besides the increase in political noise since the announcement of elections in early April, the return of the USD's strength was also responsible as reflected in across-the-board weakness in Asian currencies since. We now see USD/MYR breaching the 4.00 level within the next three months and ending the year above

that level. Accordingly, our end-2018 USD/MYR forecast is revised to 4.05 from 3.84 earlier (spot 3.95, consensus 3.81, market forward 4.00).

113

Parliamentary seats for Pakatan Harapan coalition

Out of total 222, a clear win

Better than expected

A clear victory but muddled future

A decisive victory by the Pakatan Harapan (PH) coalition led by Mahathir Mohamad may not mean an end to election-related political uncertainty. On the contrary, we can think of more political jitters, if the former ruling coalition Barisan Nasional (BN) and their supporters fail to digest the election defeat that ended over six decades of BN rule. An absence of any untoward incidences in coming days and a smooth transition of power from BN to PH may be positive for markets in the near term. But it doesn't end there.

This election result was one of the three possible scenarios we painted in our election preview note, where we also noted that a new government of Mahathir inherits a strong economy, which he will use to consolidate his power for the future, possibly paving the way for his son, Mukhriz Mahathir, to be his successor.

Having ruled the country for two decades under the BN banner, Mahathir may provide strong leadership, to begin with. However, Mahathir's old age (92 years) and potential political cracks with key allies, especially his former foe Anwar Ibrahim, whose Peoples Justice Party (PKR) is the dominant member of the PH coalition, could cast a shadow on the stability of the Mahathir administration. The test of this will be as early as June, when Anwar is expected to be released from jail on a royal amnesty.

And more economic risks ahead

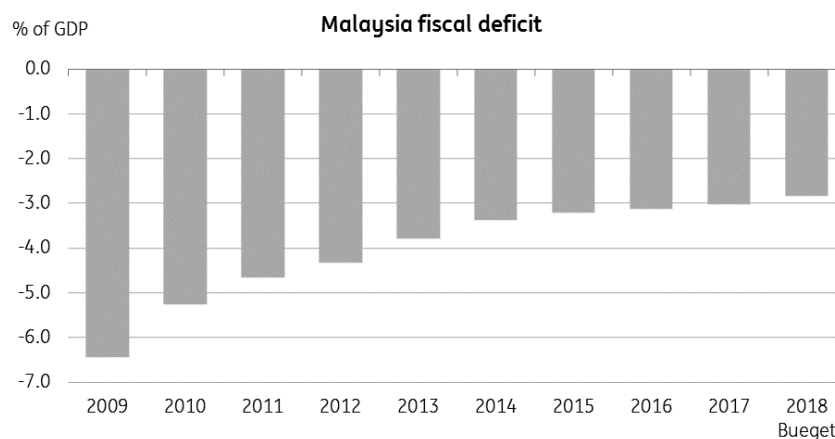
The Malaysian economy has been doing well and local financial markets have been outperforming their emerging market counterparts since last year. The sustainability of these trends hinges on the continuity of current economic policies under the new administration.

Among Mahathir's main elections promises were a scrapping of the 6% Goods and Services Tax introduced by the previous administration in April 2015. The fiscal reforms including the launch of GST and dismantling of fuel subsidies were instrumental in the consolidation of Malaysia's public finances, evident in a more than halving of the budget deficit from over 6% of GDP in 2009 to about 3% in the last year (see chart). Any reversal of these reforms by the new administration will be a setback for investors. No wonder, Moody's was quick to react to the election outcome by painting a credit negative scenario. Moody's rates sovereign at A3, on par with S&P and Fitch, with stable outlook.

Some campaign promises, if implemented without any other adjustments, would be credit negative for Malaysia's sovereign bonds. –Moody's statement.

Among other economic risks, one could anticipate Mahathir reassessing a multitude of foreign investment projects launched by the previous administration, as well as reopening the investigation of the 1MDB corruption scandal in which former PM Najib was allegedly involved. Moreover, the previous Mahathir regime was known for restrictive economic policies, prohibiting free flow of capital to and from Malaysia in the aftermath of the 1997 Asian crisis.

Steady fiscal consolidation



Source: CEIC, Malaysia Ministry of Finance forecast

But some positives

The economy has been doing well since last year and local financial markets have outperformed relative to their emerging market counterparts, for which we credit a positive terms of trade shock from rising global commodity prices, particularly the price of oil. Considering recent geopolitical developments, the upward oil price trend is your friend.

Barring any unfriendly policy shifts, Malaysia's sound economic fundamentals should sustain as the main positive for investors and markets. We reiterate our forecast of only a modest slowdown in Malaysia's GDP growth this year to 5.5% from 5.9% in 2017 (consensus 5.4%, government 5.5-6.0%). The test of this will be the release of GDP data for the first quarter next week (17 May), for which our forecast is 5.6% year-on-year growth.

However, likely negative sentiment toward the MYR strengthens our conviction that the Malaysian central bank (BNM) will continue on the normalisation path for monetary policy with one more 25bp hike in the overnight policy rate in the third quarter.

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Philippines: Strong 1Q growth

Strong fiscal spending and recovery of business spending more than compensated for slower household spending and weak exports. The strong economy can tolerate monetary tightening



Source: Shutterstock

6.8%

GDP growth in 1Q

Full-year growth forecast of 6.8% is intact

As expected

Acceleration in fiscal spending and recovery of investments underpin economic growth

Fiscal spending accelerated to a growth rate of 13.6% in 1Q from a flat rate in 1Q 2017 and 4Q 2017's 12% annual increase.

- Investment activity recovered from relatively modest growth during most of 2017.
- Construction activity improved with a 9% increase from an average of 8% in the last three quarters of 2017 and despite a high base of comparison in 1Q 2017. Government construction activity accelerated with a 25% year-on-year increase, more than 12 times the pace in 1Q 2017. More notable is private construction growth of almost 7% YoY in 1Q 2018 from just around 1% in the last three quarters of 2017.

- Business spending on production also recovered. Durable equipment investments also accelerated from 3-6% growth in the last nine months of last year.
- Household spending slowed to 5.6% from 5.9% in 1Q 2017 and from 6.2% in 4Q. We attribute the marginal deceleration to higher inflation. Food, alcoholic and tobacco consumption and transportation contracted in 1Q but spending on housing and utilities, household equipment communication and recreation accelerated.

Outlook for 2018 and beyond

We expect fiscal spending, business and household spending to continue to drive growth in 2018 and 2019. We retain our 6.8% full-year 2018 growth forecast. The moderation of inflation together with election spending for the mid-term election will spur greater household spending and also support a 6.9% 2019 growth rate. These drivers of growth can easily withstand measured monetary tightening this year and next. Market interest rates have reflected higher inflation and higher policy rates. We have seen strength in the economy during this period of rising financing costs.

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Philippines: Hikes by 25bps as inflation heats up

The central bank did not disappoint and raised policy rates by 25bp and revised inflation forecast, but we're unlikely to see another one before the fourth quarter. Expect the peso to remain volatile



Source: Shutterstock

3.25%

Overnight reverse repo rate

25bps hike

As expected

More hikes will come if inflation remains elevated

Bangko Sentral ng Pilipinas raised its policy rates by 25bps to 3.25% as concerns about higher inflation spread. The central bank signals its readiness to act further to cap second-round effects as it raised its 2018 inflation forecast to 4.6% from 3.9% and to 3.4% from 3% in 2019. Further hikes are likely if upcoming data and developments indicate inflation remains elevated above the target range for an extended period of time

We expect another hike but only in the fourth quarter. The market has expected tightening since late last month which has insulated the peso from the recent weakness of emerging market currencies.

However, with another rate hike less likely in the very near term and with weak external payments fundamentals, the peso would be volatile with a weakening bias.

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