Good MornING Asia - 12 July 2018

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Make your mind up time

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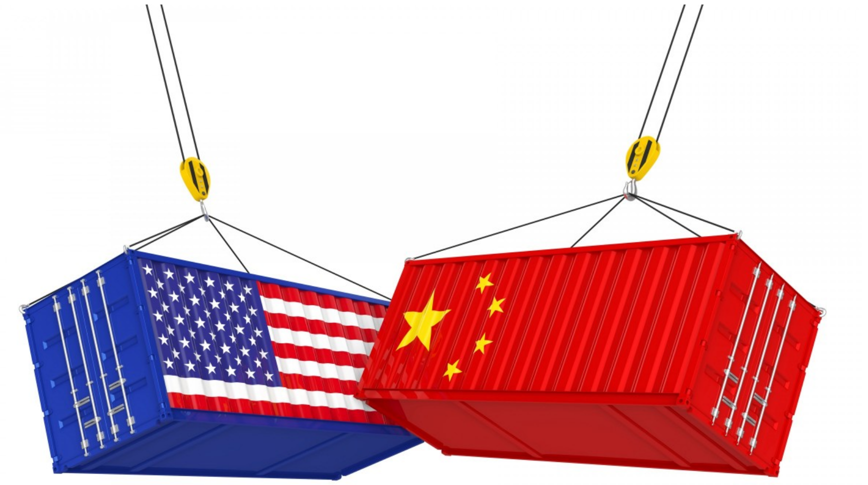

Trade war intensification gives markets another jolt

The announcement yesterday of an additional $200bn of tariffs on China in retaliation for *its* retaliation to the initial US tariffs seems like a mutually assured destructive (MAD) pattern of actions from both sides. A pertinent question is, 'what next?' To which the US administration has already told us, '$500bn'. Then after that? What else? NAFTA talks break down and that arrangement falls apart? It doesn't look that improbable from where I am standing. Tariffs on EU autos followed by further retaliation from the EU? That too seems to be looking more likely than not.

Each time we take a further step into the war-zone, markets have a little wobble like the one they have just had. Equities sell off a bit, then, so long as there is no further bad news for a week or so, they begin to sit back up again. Bond yields too. Yes, they are down again in the 2.80% area when only a few months back, it looked as if we were heading for 3.5% on the 10Y US Treasury. But this still leaves them in a non-descript range that neither suggests a strong outlook, nor a catastrophe.

Asian FX also looks somewhat weak today which is not wholly surprising, but the sell-off in June has been followed by greater stability so far in July, and at the moment, ranges are largely holding. It will be interesting to see whether the FX pattern rotates to penalise the commodity currencies of the region, now that commodity prices have decided that the global demand outlook really is looking quite bleak (take a look at the price of copper, or the CRB industrial metals index). That could put the ringgit (MYR) and rupiah (IDR) under heavy downward pressure, as well as the Australian dollar (AUD), which continues to head lower on a trend basis. Next stop, USDAUD 0.70?

My point is that the movements towards protectionism are significant and lasting step changes that will reduce trade volumes and economic gains from trade. They will raise prices of goods and lower real incomes and employment across the globe. They will raise input costs and squeeze the profit margins of producers, and they will stifle innovation and productivity growth, as the opportunities to market new products profitably become curtailed. This really does not merit the occasional small temporary correction, followed by swift recovery. But instead, deeper, and prolonged selling.

For the bulls out there, who look for some respite from Fed tightening as trade wars begin to slow employment and investment...Yes, the Fed may in time be swayed to back off a little. But that would not be a big cause for celebration. If it does happen, it will be for all the wrong reasons. Markets rallied at the end of 2007 as economic bad news spurred thoughts of more radical Fed policies. These policies did arrive, but that did not prevent market collapse first.

Asia today...BoK

The Bank of Korea (BoK) will most likely decide for another month to keep official policy rates (7-day repo rate) steady at 1.50%. Our own forecasts do not have the BoK hiking again this year, based on our expectations for some further slowdown in global growth and market weakness. But a poll of Bloomberg forecasters still shows an end of year hike. So is this idiotic? Well, the consensus is a slow moving beast, and it could just be that it is taking forecasters a long time to jettison expectations for some 2018 tightening by the BoK. Calendar year-ends do provide a very real impediment to the forecasting community, and sometimes hold up the adjustment process.

But there is a scenario in which they might not be wrong to hold onto some tightening risk, though to get there, we will need to see the won (and most likely all other Asian currencies) weaken substantially further in an environment of trade-war generated global slowdown. That would result in imported inflation and might be enough to see central banks tightening. it isn't as crazy as it sounds.

CRB index of industrial metals prices

Source: Bloomberg

CRB index

US CPI the main event in the G-7

Ignoring the NATO summit which is high on political grandstanding, and low on direct economic impact, the main event in G-7 markets today will be US June CPI inflation. And this will come painfully close to 3.0%YoY (consensus 2.9%) with even the core rates pushing higher. PCE and core PCE will be released at the end of the month. Both measures are already at or above the Fed's target of 2.0%YoY. So although there are voices of reason, such as Bullard and Kashkari, the majority of the Fed will likely see no reason to change their view of another couple of hikes this year and more next, at least based on the inflation picture.

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Article | 11 July 2018 China

China: Changing the nature of retaliation on trade

It may not be until September that we'll be able to assess the extent of China's qualitative retaliation to the overnight announcement by the US...

Qualitative retaliation, but how?

Chines imports from the US reached only $168 billion in 2017. So, after tariffs on $34 billion worth of goods, with an additional $16 billion in the pipeline, the overnight announcement (11 July) of a 10% tariff on a further $200 billion of goods means that China will likely retaliate "qualitatively", as previously indicated by the Chinese authorities.

Here are some measures we believe are possible (definitely not an exhaustive list). The uncertainty surrounding such qualitative retaliation could be a cause of concern for markets.

1. We believe that the most likely "qualitative" retaliation is a version of the "Lotte Department store model" (a Korean store forced to shut down by the Chinese government after missiles were installed on land the company sold to the South Korean government). As they are opening up their market to the rest of the world, China should tread cautiously in making life difficult for US companies operating in China. But, they could, if they feel they need to, make US business operations on the mainland more cumbersome, making it clear that this is only a retaliation to US tariffs and specific to US companies. It is likely that European and

domestic brands would emerge as winners.

2. China can also limit tourists visiting the US, bringing business worth $115 billion in 2017 according to Xinhuanet. China will probably not limit students going to the US for study because these students are a source of future talent for the country.
3. The final weapon is not the currency, but US treasuries. Even reshuffling the foreign exchange reserve portfolio slightly by selling some US treasuries and investing more in other sovereign bonds could push up US borrowing rates.

Quantitative retaliation is on the cards

Apart from qualitative measures, China could continue its retaliation quantitatively.

China could impose a higher tariff rate on US goods. They could also impose import quotas on US goods though this would probably violate WTO rules, and as China wants to maintain its strong reputation in the WTO, this would not be ideal.

China is more likely to win the trade war

When the US started the trade war, it turned away from a free-market model to a more planned economy. China had previously operated as a planned economy for many years.

China has already announced that the tariffs collected from US would be given back to Chinese companies affected by the trade war. China can also provide tax relief for affected exporters and provide incentives for exporters to sell their goods, either in the domestic market or through exploring possibilities in non-US foreign markets.

All these measures could come into effect more quickly in China than in the US, which has a more complicated administrative process.

This is not just a trade war – but rivalry for global economic leadership

China has started to pour money into technology R&D. But it will take some time for this to bear results. Meanwhile, we expect that the US administration will continue to put pressure on Chinese technology companies operating in the US.

USDCNY forecast now at 7.0 by the end of 2018

Our revisied USCNY forecast at 7.0 by the end of 2018 seems more likely than before, especially after foreign reserves rose in June. We believe that the yuan is going to depreciate against the dollar in the middle of this trade war. A 7.0 may look weak but compared to other Asian currencies, it is not the weakest.

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