

Good MornING Asia - 14 June 2018

US Fed hikes as expected, and puts a glossy spin on the economy: But there are a number of aspects of this rate decision that we find worrying...

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Fed hikes - puts a glossy spin on the economy

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Source: Federal Reserve

"Bob, I got a bad feeling on this one, alright? I mean I got a bad feeling!"

No prizes for googling the quote above from Oliver Stone's 1986 film, "Platoon", but this was what popped into my head immediately on waking up in the middle of the night and unable to fall asleep, sneaking a look at my phone to see what the Fed decision had been (I'm a 12-hour time zone away). For the house view, [please see the note](#) by my Developed Market colleagues.

More often than not, when your subconscious tells you something, it's a good idea to listen.

So how does my conscious-self rationalise this vague sense of foreboding this morning? This isn't going to be easy, because if it was so obvious, my conscious-self should already have figured it out.

The main thing that I think is nagging at my sub-cortex is the speeding up of rate hikes in 2019. The median FOMC view is now that this rises to 3.1% (so 3-3.25% in practical terms), above what the longer run projections of 2.9% (so 2.75% to 3.0%) that might be viewed as the equilibrium rate.

The slight overshoot of the longer-run value is not new. What is new is that this now happens earlier (in March this was not until 2020), and following four hikes (not three or four) in total in

2018.

In short, Powell has picked up the pace. To examine why, let's start with one of Powell's quotes from last night. The US economy is "...in great shape". That is a pretty unambiguous start.

But he follows this up with confusion over the lack of wages growth, despite the fact that "...The main takeaway is that the economy is doing very well. Most people who want to find jobs are finding them, and unemployment and inflation are low," This was, he said, a "puzzle".

Well, yes, it is different to how the economy normally evolved in previous business cycles. But maybe the old relationships on which Fed policy was based have changed, even if they still work after a fashion. Have you considered that Mr Chairman? At that point, the unemployment/wage-inflation trade-off that the Fed used to underpin all of its decisions with, may no longer give you right answers.

When I'm not sure what signals I am getting, like navigating through my apartment in the dark to avoid waking the members of my family that don't have to get up at 5:45am each morning, I tend to go slowly to avoid colliding with doors, furniture etc. Powell's approach to uncertainty seems to be to speed up.

Powell was equally dismissive of the impact of the brewing global trade war on the US economy. "Right now, we don't see that in the numbers at all. The economy is very strong, the labour market is strong, growth is strong. We really don't see it in the numbers. It's just not there". Although he then conceded that the Fed had heard of firms postponing investment exactly because of such fears. Hmmmm.....is it there, after all, Mr Powell?

There are of course plenty of other aspects of the meeting we could fixate on - the decision to provide a press briefing after every meeting (it's not just me, this got a collective groan at the morning meeting today - central banks have no better idea than most of us what is going on in the economy, why do we need more of this?), or the technicalities of the interest rate on excess reserves, which was only raised 20bp to push the effective Fed funds rate back towards the middle of its range.

But in the end, I guess this all boils down to a barely concealed complacency that I find worrying in the face of so many domestic (Ben Bernanke's prescient Wile. E Coyote comments) and international (Trade war) uncertainties.

2.9%

Fed's long run rate expectation

3.1% - where they expect to be at the end of 2019 (not 2020)

ECB next - not complacent enough?

One thing you can't criticize the ECB about is complacency, indeed, they could do with being a little less cautious. But we anticipate some movement towards a taper of QE at today's meeting.

Things to watch out for:

1. Did the governing council discuss the taper?
2. If so, did they reach a decision on when this will start (September?)
3. And if so, did they come up with a decision on when it will end?

Markets will be disappointed if, after Peter Praet's comments recently, the answer to 1) is "No". And they will be rightly disappointed if the answer to 1) is "Yes" but 2) is "No", though this would be in keeping with the glacial pace at which most ECB decisions are taken. Whether this is September, though it another matter. Surely enough information has been obtained to enable the ECB to determine if the economy still warrants emergency QE support. To me, the answer is an unequivocal "Yes" it has. If so, why even wait until September? Start next month. As for when it ends though, there is more room for discretion. Date dependent policies (like the Fed dot projection - why have they not ditched that?) are less defensible than data dependent policies. So they might give an indication, but keep the exact date open. That would be fair.

A combination of positive responses to questions 2) and 3) could see the EUR appreciate against the backdrop of a Fed that is talking a very optimistic game, but if the stock market is any guide, is beginning to worry financial markets with their gung-ho approach.

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China relaxes rules for foreign investors to take money out

China has relaxed rules for foreign investment schemes to take money out of the country in a bid to open up the capital account. But the new rules need to be tested to gain investor confidence



Source: Shutterstock

China lifts capital outflow controls to lure inflows

The central bank has relaxed outward remittance rules for two foreign investment schemes in China (namely QFII, qualified foreign institutional investor programme and RQFII, renminbi qualified foreign institutional investor programme). These schemes allow foreign investors to bring money into China and invest in China's equity and bond markets.

In the past, taking money out of China was difficult and there was a lock-in investment period. This has now been dropped though other rules continue to apply. For example, the remitted amount must be taken after tax.

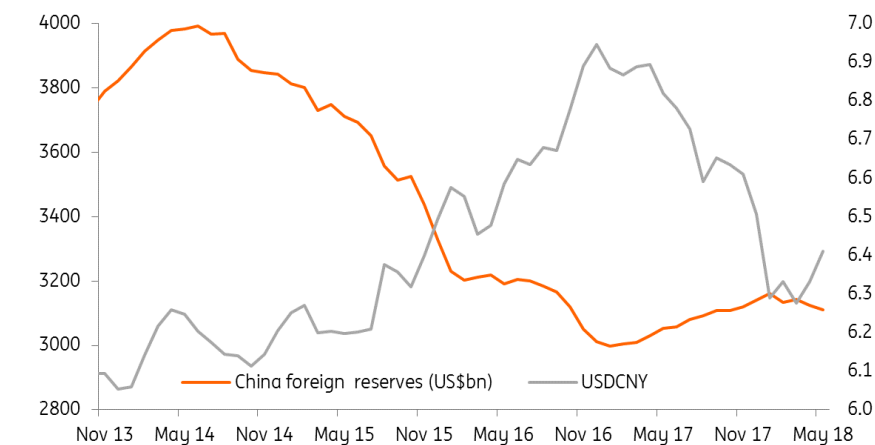
The central bank has introduced these measures to appease foreign investors who had been concerned about investing in the onshore Chinese market because of rules governing when they could take money out. It hopes this will encourage two-way flows of capital.

But foreign investors might not have trust in the policy immediately

But we believe that this relaxation has to be tested, especially at times of rapid capital outflows from onshore to offshore. Between 2014 and 2016, capital controls were applied to outflows and this situation could be repeated.

Unless foreign investors gain more confidence in the ease of taking money out of China, we don't expect a lot of inflows from the QFII and RQFII schemes.

Outflow pressure increases with a weaker yuan



Source: ING, Bloomberg

Central bank must show that outflows are allowed even when the yuan weakens

As we expect the yuan to weaken further in 2018 to 6.60, outflows from funds operated by QFII and RQFII should arise occasionally. If the central bank can show foreign investors that it is willing to stick to its new outward remittance rules even when the yuan weakens, then more foreign investors will be encouraged to invest in the onshore market.

China will then be able to attract more inflows into the onshore market when sentiment is bullish. MSCI is going to include more A-shares into its funds, which may give demand for these shares a push. If these funds are able to return 1.5% in 2018, they will be able to make a profit that offsets the exchange rate depreciation of 1.4% from our USDCNY forecast.

New outward remittance rules could encourage foreign investors to invest in the onshore Chinese market but only if the central bank can give more assurance that these investors can take their money out when they want it. This would ensure a genuine two-way flow of capital, which is a preparatory stage for further liberalising the yuan exchange rate. Eventually, the yuan could float like other major currencies. But the prerequisite is the opening up of the capital market.

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