

Good MornING Asia - 14 May 2018

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"Get it Done!"

The latest Tweet on ZTE - the Chinese Telecom producer virtually brought to its knees by a US parts ban, but now appearing to get a reprieve with Trump's latest tweet telling the commerce department to "get it done" ("it" in this case is removing or amending the parts ban imposed on ZTE) is interesting from two different aspects:

1. It reaffirms what we have observed about Trump's negotiation style - talk very loudly, but carry a small stick and;
2. Be careful what you wish for - the ZTE affair was further encouragement for China to seek its own tech solutions rather than rely on imported hardware - "Made in China 2025"

At least it suggests that despite all the initial bluster, the current administration is prepared to take a pragmatic view on decisions (opens the possibility for a similar path on the Iran deal and indefinitely defer sanctions?) and this raises some further hope in terms of additional trade talks over the coming months, with China's Liu He visiting Washington this week..

On the other big Geopolitical story - N Korea, there is now talk of US investment in N Korea, if verifiable and irreversible moves towards denuclearisation take place. That would be an astonishing result, though not particularly market moving.

Crying Wolf

I think I am going to start a list of all those predicting an imminent recession or market collapse, as this itself may give some sort of signal about the future - though possibly a contrarian one. The latest offering appears to cite April Korean exports as a bellwether for imminent stock market corrections. Perhaps the authors of that note may care to take a look at the data underlying the weak (-1.5%YoY) headline. Softness in the lumpy shipping component (-75%YoY) dominated, with the bit we have been worrying about - semiconductors - racing away at 37%YoY.

We'll keep watching our preferred indicators, but we will also try to think about the data before sounding the alarm bells. So far, we see nothing to get too alarmed about.

Day / Week ahead

For the week ahead, the first question to be raised will be how the market will respond to the defeat in Malaysia of the incumbent Barisan Nasional (BN) Party by veteran politician Dr Mahathir Mohamad and his Pakatan Harapan coalition. Early hints over the weekend about key cabinet members are likely to be reasonably well received by markets and may temper some initial negativity on the result. For more detail, [see the note](#) Prakash Sakpal wrote in the immediate aftermath of the result last week.

The big release of China activity data will be some of the most closely watched out of Asia this week. April retail sales, industrial production and fixed asset investment will give a clean, comprehensive look at activity post-lunar New Year distortions. We think the broad message on activity should be encouraging.

Japanese 1Q18 GDP released mid-week will show a break in the chain of strong GDP numbers, though that merely puts Japan into the same boat as most of the rest of the G-7 in 1Q18. This is probably an aberration, not substantive. CPI data released later this week will drop sharply to about 0.7%YoY from 1.1% previously. That is more substantive, and should silence any remaining chatter about BoJ exit strategy for a while.

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China to speed up “Made in China 2025” plan

Possible collapse of trade talks is likely to increase uncertainty for Chinese production. But we've kept our GDP growth forecasts unchanged as we expect investment in “Made in China 2025” to offset any potential loss from net exports



Source: Shutterstock

We are sceptical about the outcome of trade talks between China and the US over the coming months.

According to media reports, the US demands are mostly related to China's national strategy, “Made in China 2025”. Given that China maintains these demands are unreasonable. Therefore, it is difficult to see Vice Premier Liu He's forthcoming trip to the US yielding any tangible results. The most likely outcome for the second round of trade negotiations will be a stalemate.

Stalemate complicates high-tech production supply chain

Exporters that could be affected by the respective US and China trade demands should think hard about their business or at least contingency plans. The increasing uncertainty arising from a stalemate situation will complicate business decisions on future investments.

We believe that with the potential negative impact on the economy stemming from a more

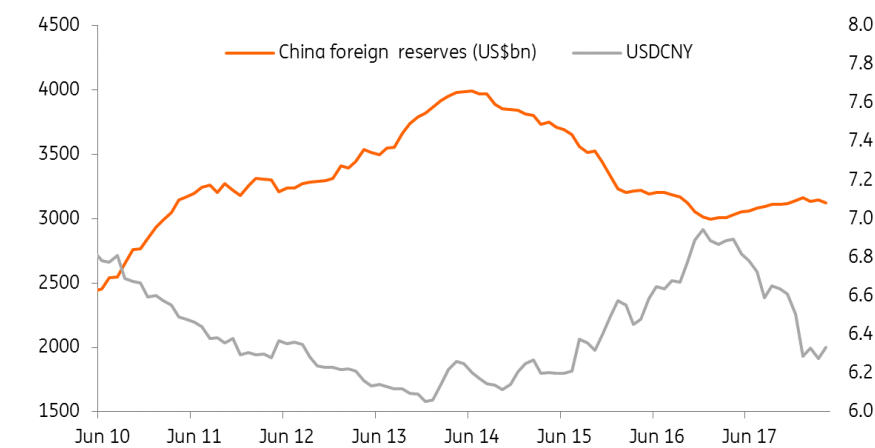
difficult trade backdrop, this would encourage the central bank to appreciate the yuan at a more moderate pace. This is one of the reasons that we have revised our forecast of USDCNY from 6.10 by the end of 2018 to 6.33.

We still expect the yuan to appreciate in 2018 because depreciation would encourage capital outflows, leading to a rapid depletion of foreign exchange reserves similar to the situation between mid-2014 and late 2016. The central bank will try to avoid repeating history especially when the economy faces additional risks from trade tensions.

Central bank set to appreciate the yuan at a slower speed

Moreover, a few percentage points of yuan depreciation will do little to alleviate the trade pressures that China says the US is placing. Indeed, it would likely make negotiations even more fractious, as the US could claim, China was manipulating the currency to boost exports.

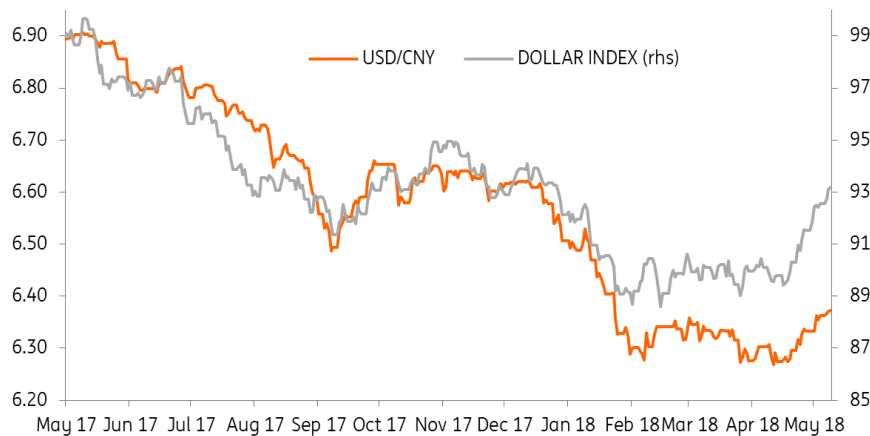
PBoC to prevent foreign reserves from falling again



Source: ING, Bloomberg

We can see support for such reasoning in the recent path of USDCNY. Even when the dollar index strengthened more than 2.5% in April, the yuan only depreciated 1.2% against the USD. This should result in yuan appreciation against the dollar in 2018.

The yuan has not followed the dollar as closely as before



Source: ING, Bloomberg

Why we've kept our China GDP growth forecast unchanged

The US sanctions on a Chinese telecommunication equipment producer has exposed the weakness of China in terms of its self-sustainability in the production of high-quality tech parts as well as the lack of its smartphone operating system. But the timing of all this is not too bad, given that China's GDP is growing at a rate of 6.5%. The economy can afford to invest more in this sector to achieve self-sustained high-tech sectors as soon as possible.

We expect that fixed asset investments in high-tech manufacturing and infrastructure in 2018-2020 will grow to near 10% YoY and 20% YoY from the latest 3.8% YoY and 13% YoY, respectively. This is likely to boost GDP growth, which will offset the loss of net exports and related production and logistic services following from the US sanctions and potential tariffs.

This is why we have kept our China GDP growth forecast unchanged at 6.8% for 2018 and 6.7% for 2019.

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China: Upbeat on activity data

We are optimistic on China's retail sales, industrial production and investment activities in April. We are not particularly worried about the impact of trade tensions on China's growth, as these concerns will most likely speed up investment in the country, which could offset potential losses on exports and related activities



Source: Shutterstock

Retail sales growth to be robust

We expect China's retail sales growth to be 10.0% in April, slightly softer than 10.1% in March, supported by higher energy prices, healthcare services, clothing and catering. In other words, we expect consumption to be robust.

And there is little reason to think this will change in the coming months. Though trade tensions are escalating, and we do not see the risks going away any time soon, consumption is unlikely to be affected if the trade threat does not affect the job market.

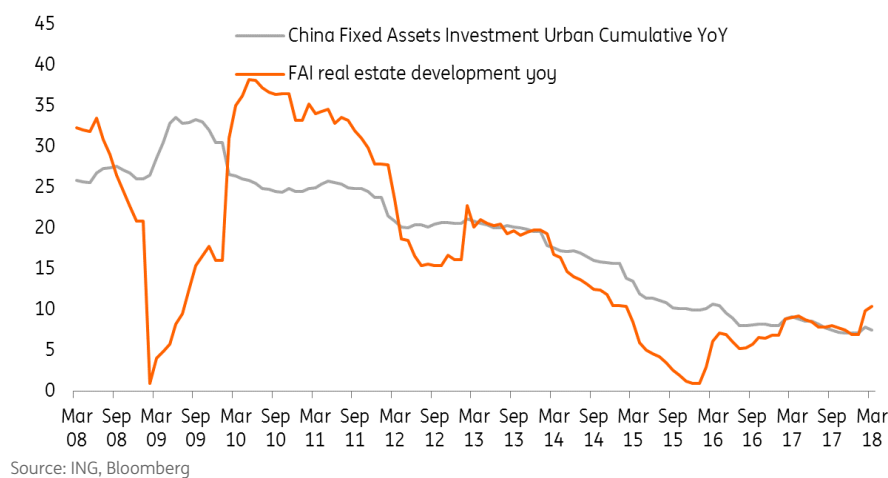
In fact, we believe that China could increase workers in high-tech sectors. That means demand for labour could shift from manufacturing to R&D. This could even support average wage growth and therefore spending.

Investment growth to come from real estate, but R&D will play a bigger role

The property market is hotting up again, and we expect this to support fixed asset investment growth of 7.7%YoY in April from 7.5% in March. It will mostly be residential and retail properties that have supported the market.

In the coming months, investments in R&D in high-tech manufacturing will boost fixed asset investments in China. This will continue until the country has reached a stage when it can produce its own high-quality semiconductors and smartphone operating system. That could mean a few years of high investment growth in these areas.

Real estate supporting investment growth



Industrial production growth back to normal

After a short month in March, April's industrial production should resume to normal capacity, and due to a low base last year, we expect industrial production to grow a bit faster at 6.3%YoY in April compared to 6.0% in March.

Trade tensions have not yet had a material effect on industrial production in April. But we believe that some businesses may begin to consider moving some production lines out of the mainland. The good news for China is that this takes time. So the immediate effect on manufacturing in the coming months should be negligible.

But the complicated supply chain could create uncertainty in production and investment activities. Decisions may be delayed if businesses take a "wait and see" approach. When decisions are delayed, production activities will also be delayed.

Fortunately, China is finding ways to become self-sustained in high-tech areas faster than planned (the plan has been by 2025). This could support some production activities.

Investments are likely to offset the potential loss of net exports and related activities from escalating trade tensions. Therefore we keep GDP growth forecast unchanged at 6.8% for 2018.

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Japan: Slow start

It is becoming quite “the thing” to start the year weakly... but with Japan there is genuine room for optimism

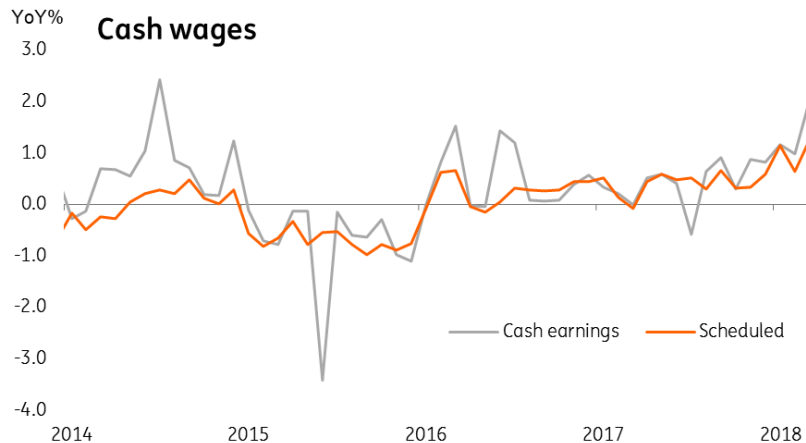


Source: Shutterstock

It is becoming quite “the thing” to start the year weakly. The US does it almost every year. Europe also seems to have recorded a soft patch in 2018. Japan, too, seems to have started the year in a less than convincing fashion. Consensus opinion has Japan growing at only 0.5% quarter-on-quarter in 1Q18. It is easy to blame bad weather for economic weakness, only for it to turn out that the economy was genuinely weak all along. But in Japan’s case, we think there is genuine room for optimism.

Wages are rising at the fastest rate since 2014

A recurring theme in these monthly notes has been Prime Minister Shinzo Abe's attempts to get Japanese firms to pay higher wages, especially regular wages (not bonuses) to spur consumer spending. March cash wages rose 2.1% year-on-year. This might not sound like a lot, but wages haven't risen this fast since 2014. Real wage earnings in March were also 0.8% higher than a year ago.



Corporate profitability is picking up too

Now, these income numbers may look like a single month's aberration, and indeed, it is far too early to get excited. But the wage figures also tally with one of the other fundamental indicators we have been tracking – namely corporate profitability. This, especially in the manufacturing sector, has been growing strongly for some time, and it now tentatively looks as if some of this gain is being passed on to Japan's workforce.

If this wage growth begins to show up in stronger consumer spending growth (not yet all that evident), then there really will be a convincing story of a profit-led, earnings supported, consumer spending upturn taking root.

Inflation still unlikely to reach the BoJ's target, but no need to worry

All that would be missing then as far as the Bank of Japan (BoJ) is concerned would be some inflation. Unfortunately, we don't believe that this is likely to ensue to the degree needed to reach the BoJ's 2.0% target. That doesn't mean the economy remains too weak, rather than the 2% target was always unrealistic and unachievable.

As for the BoJ, we continue to believe that they are ready and willing to consider ratcheting down their asset purchase programme. But we think that they would prefer to do so under the cover of some tapering by the ECB. The recent softness of Eurozone data suggests that this is not going to happen as early as we previously thought, though this is more of a delay than a change of forecast.

Domestic politics means the Japanese economy is not in the clear, yet

But what might alter our outlook for Japan and the BoJ is the political backdrop. PM Abe's hold on the top political job in Japan has been heavily challenged by cronyism scandals around preferential treatment for new schools. Were Abe to be forced to step down, the strongest of the three prongs of Abenomics would likely fade, and that would likely need the BoJ to pick up the slack – with the JPY a likely victim of such additional monetary policy easing.

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Hong Kong: Upgrading GDP growth for 2018

The extremely strong growth of the Hong Kong economy in 1Q18 surprised us. The growth mainly came from consumption created by the wealth effect from rising property prices. As we expect home prices to rise another 5% to 10% in the second half, consumption will continue to be strong and so will GDP growth. We are revising upward our GDP forecast for 2018



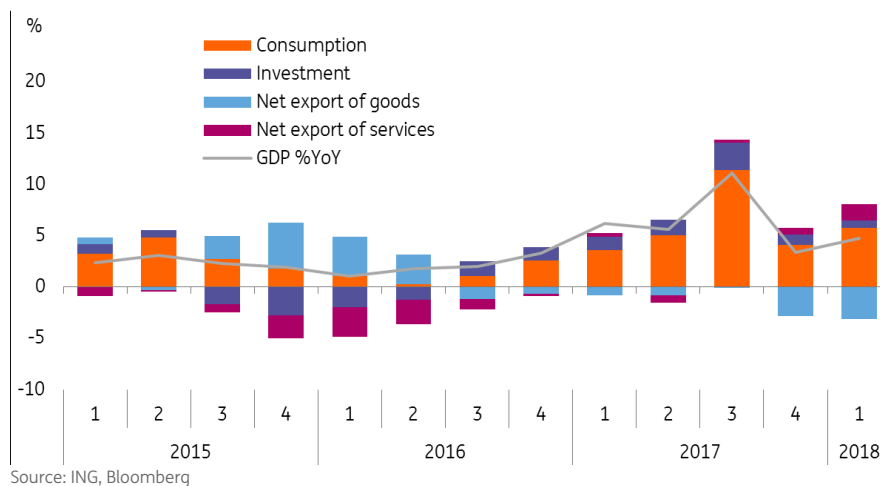
Source: Shutterstock

Surprisingly strong GDP driven by consumption

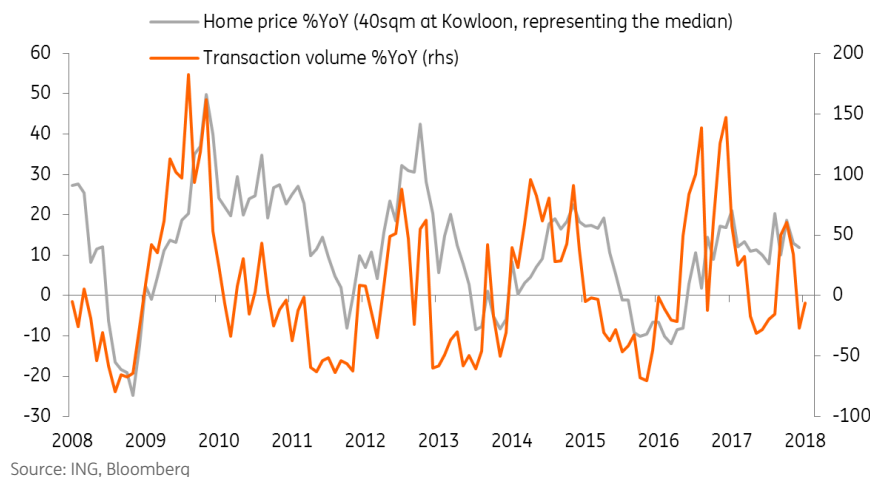
Hong Kong GDP grew 4.7% year-on-year in 1Q18, which is strong but consumption is even stronger at 8.6%YoY. We underestimated growth at 3.4%YoY in 1Q, the same as consensus.

Consumption growth could be due to the wealth effect of rising home prices, which have increased more than 20% for most housing units in 12 months. Though other components also grew at a decent rate, we argue that those were mainly due to the base effect from 1Q17.

Hong Kong strong growth driven by spending



Housing prices keep rising



Home prices will continue to rise albeit at a slower pace in 2H18

Home prices are not likely to stop rising unless there is a big negative unexpected event in the market. Rising interest rates from more Federal Reserve rate hikes would certainly increase the burden of mortgage borrowers, so home prices would rise at a slower pace. But we do not expect a fall in property prices. With new flats becoming smaller, property developers are able to keep new homes affordable to young people with wealthy parents.

In addition, rising home price expectations would also induce existing home owners to refinance their mortgages, even at high interest rates, to invest in an additional property, hoping for some capital gains in the longer term. In other words, the wealth effect would continue to exist for a few more quarters.

Uncertainties mount from trade tensions

On the other hand, we believe that the escalating trade tensions could disrupt Hong Kong's re-export businesses. Those activities would be mainly shipping, port, logistics and trading businesses.

We revise Hong Kong GDP upward to 3.8% in 2018

We maintain our GDP forecasts for the remaining months of 2018, as good growth from consumption will be offset by trade-related service activities. But the strong growth in the first quarter is sufficient for us to revise our GDP forecast for 2018 to 3.8% from 3.4%.

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