Good MornING Asia - 15 August 2019

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In this bundle

Opinion | 15 August 2019

Fear Factor returns to markets

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Time to face up to some hard truths

I've talked at length about yield curve inversion in this note in the past, noting that if we were to adjust it for central bank asset purchases, which total over $11tr, then it would likely not be all that flat at all. But whether it has inverted in "real" terms or not, and the 2s10s slope is now virtually flat if not actually inverted, recent moves do indicate a distinct flattening. In my view, that isn't out of whack with what is going on in the wider world. James Knightley adds to that narrative here.

For sure, the US economy doesn't quite adhere to this story, with core inflation nosing higher, and a still-strong labour market. But indicators of business investment, like core goods shipments and inventories, haven't looked all that perky for some time, and it is a fair bet that the trade war is crimping business confidence, and at least, delaying some investment plans for lack of a clear route forward.

Overnight, a more somber assessment of the trade war from US Director of Trade and Manufacturing, Peter Navarro, has nudged the market to the view we expressed yesterday - that despite the delay of implementing some of the new tariffs, nothing had really changed. Stock markets in the US have dropped sharply. Asia will likely follow suit this morning.

Outside the US, China data yesterday was rather disappointing. Iris Pang offers a sober assessment of the situation here. In spite of government measures to keep the economy ticking along on a drip-feed of infrastructure spending. industrial production at 4.8%YoY hasn't been this weak outside of a few one-month dips since the early 1990s. Retail sales were also soft, and fixed asset investment, at 5.7%YoY, is stable, rather than accelerating. So the world's second-biggest economy is showing clear signs of a slowdown, even if the world's biggest economy is steady, though uninspiring.

Look further afield - Europe for example - and even outside the Brexit-inspired mess of the UK, growth is notable by its absence. Here's a link to a piece on Germany, which has just registered negative growth. And if you haven't had enough on Brexit, here's another looking at the "no-deal" likelihood. Elsewhere, non-China Asia is still coming to terms with a global tech slump.

Yep, I think the curve slope is reflecting the global direction fairly well. I just don't think it adds much extra value to a story that is already fairly clear. if you want the market to hold a mirror to the global economy, I think the commodity markets, which are real assets after all, and devoid of much of the flim-flam of financial products, do a much better and more consistent job. The ratio of gold to copper prices, for example, is worth comparing against your favourite measure of global activity (inverted). Chart below.

Gold Copper ratio

Source: bloomberg

Asia Day ahead

Australian employment data are our regional equivalent of US non-farm payrolls and every bit as quixotic. But this data release also has the power to drive markets, especially now the RBA is firmly in "active" mode. Yesterday's 2Q19 wages data didn't add much to the picture. A strong employment figure coupled with a rise in the unemployment rate could dampen thoughts of further imminent RBA easing and give the AUD a lift - and vice versa.

Meanwhile, Independence Day in Korea means a speech from President Moon - will he try to mend ties with Japan, or will this be a more nationalistic speech that draws a further reaction from Tokyo? My gut feeling is the latter. It plays better to local politics. But it might not be so supportive for Korean stocks and the KRW...

And here's some further commentary from Iris Pang on yesterday's weak China data "The cause of such low manufacturing growth was shrinking car manufacturing, which reflects declining demand for car ownership in China. This was also reflected in negative sales growth of cars in the retail sales data. The underlying cause was the trade war and technology war, which has weakened consumer confidence. These two factors will stay for a long time. China will push forward its planned infrastructure projects together with easing monetary policy to keep growth stable".

Indonesian trade for July, which should see the trade balance swinging back into deficit and Philippine overseas worker remittances round off the main data events of the day in Asia. Neither is likely to provide a massive boost to confidence.

US retail sales for July will be the main event out of the G-7 today. They have been holding up well so far. But that probably means the market risk is skewed to the downside, even if the data risk is fairly balanced.

Author

Olivia Grace
Editor
olivia.grace@ing.com

Julian Geib
Junior Economist, Global Trade
julian.geib@ing.de

Zoltán Homolya
Economic research trainee
zoltan.homolya@ing.com

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780

ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig
Senior Economist, Healthcare & Technology
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

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

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

ASEAN Morning Bytes

General market tone: Risk-off. The relief rally from President Trump pushing back next round of tariffs on Chinese goods to December was short-lived as disappointing data from China and Germany and fears of the US economy facing a recession pushed investors for risk-aversion again.

EM Space: Global recession fears to knock down risk sentiment on Thursday

- **General Asia:** Emerging markets look set to pullback today as global recession fears mount following dismal China's industrial production and Germany's GDP data, while the risk of the US slipping into recession becomes more prominant with latest Treasury yield curve inversion.
- **Malaysia:** In yet another downside surprise, CPI inflation slowed to 1.4% YoY in July from 1.5% in the previous month on lower utility and transport components. At only 0.3% year-to-July we don't see inflation becoming an issue for the economy anytime soon. We have cut our full-year inflation forecast to 0.8% from 1.0%. With persistently subdued inflation we don't think the central bank (BNM) will be left behind in its easing cycle as a global headwind to the economy continues to be on the upswing. We now anticipate two more 25bp BNM rate cuts taking the overnight policy rate down to 2.50% by end-2019.
- **Thailand:** A Bloomberg story quoted Labor Minister Chatumongol Sonakul warning against

the adverse impact of the US-China trade tensions on the Thai economy and the hurdle this poses for another planned hike in minimum wages, currently about THB 330 (US$ 10.7). Indeed, the economy needs more stimulus and a wage hike could have been a part of it. The uncertainty about fiscal stimulus means the central bank (BoT) will have to do all the heavy-lifting to boost growth. The BoT started its easing cycle with a 25bp policy rate cut earlier this month. We expect one more rate cut before the yearend.
- **Philippines:** Car sales perked up in July with a surprisingly strong performance in the passenger car segment where sales jumped by 34.7% YoY and commercial vehicle sales chugged along with a 6.4% increase. However, favorable base effects may have had a lot to do with the strong year-on-year gains. We expect easier economic policies, especially continued downward grind in the BSP policy rate to sustain the strength further.

What to look out for: US retail sales

- Indonesia trade (15 August)
- Philippines remittances (15 August)
- US retail sales (15 August)
- Singapore trade (16 August)
- Malaysia GDP (16 August)
- Hong Kong GDP (16 August)
- US consumer sentiment (16 August)

Author

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

A weak Chinese economy

Chinese industrial output reaches a 17-year low, echoing the recent slow credit growth. It's the result of the government opting for stability rather than speedy growth. But it also shows that without the right stimulus, low consumer demand will reflect lower production. Even President Trump's tariff delays offer little help

People crossing a Shanghai road

Stable growth, but industrial production hit hard

Chinese fixed asset investments grew by 5.7%YoY in July, slowing slightly from 5.8% a month ago with infrastructure projects still the main driver of investments.

But industrial production was hit hard and grew by only 4.8%YoY from 6.3% previously. This kind of growth was last seen in January 2002, which effectively means the current manufacturing situation is worse than it was during the global financial crisis.

- The main cause is the contraction of cars and related manufacturing parts , which has led to very weak headline industrial production growth.
- Infrastructure projects have begun to enter the construction phase after projects received funding from local government special bonds. But the details show their contribution to industrial production was quite small compared to the negative impact of car-making on overall production.

Retail sales have slowed down to 7.6%YoY from 9.8% in June. Consumption sentiment hasn't been helped by tax and fee cuts, as consumers tend to save the additional income rather than spend during challenging times. We see that spending on luxury items such as jewellery and cars declined while spending on essential items grew steadily.

4.8% **Chinese industrial production**

The weakest since Jan 2002

China needs to speed up stimulus

The stability picture echoes the recent slower credit growth and a shrinking in shadow banking activities and implies that the government prefers stable quality growth over exponential growth.

But it's also time to consider whether the Chinese economy needs more stimulus. It's mow divided into two parts; one is stimulus driven, another is regular activities. When regular activities face headwinds, there is a need for stimulus to keep the economy running to avoid rising unemployment.

To keep GDP growth above 6%, infrastructure projects that have received funding from local government special bonds should increase their pace, which in turn should help industrial production. At the same time, fiscal stimulus should be accompanied by easing monetary policy to divert liquidity to targeted borrowers, especially exporters.

Target required reserve ratio (RRR) cuts of 50 bps, together with targeted short-term interest rate cuts of 5 bps are expected in 3Q as well as 4Q.

Tariff delays provide temporary respite, but tech firms to suffer longer

The US administration has delayed imposing the additional 10% of tariffs on some of the $300 billion goods to 15 December, originally due to come into effect on 1 September.

So Chinese exporters and manufacturers don't need to front load shipments for the American holiday season, but unless the demand from the US is very strong, we don't expect this temporary delay to cheer up Chinese exporters.

China has not claimed victory on this tariff delay, and it should not, as the US administration could add other hurdles for Chinese companies, especially technology companies. American companies continue to be banned from doing businesses with Chinese technology companies that have been included in the US' entity list.

It is not all bad for China's future. We have argued this will force China to innovate its own hardware such as chips and its own operating system, for instance. Even though this may take a few years, China's threat to the US will not disappear. China realises this, and will continuously pour in more resources to achieve technology independence.

USD/CNY has followed its own orbit

After crossing the 7 handle, USD/CNY seems to have its own orbit. Overnight, even the US dollar jumped on the back of the tariff delay announcement while the offshore yuan strengthened from 7.10 to 7.04 at the time of writing this note.

Crossing that 7 line is a mere gesture on China's part to show its discontent with the progress of the trade talks. But this is not really a solution for exporters when they face high tariffs and fewer export orders.

So the activity data and the delay of tariffs doesn't change our forecast of USD/CNY at 7.10 by the end of 2019.

Upcoming trade and stimulus plans may help

The activity data in July was weaker than our expectations but we need to see if there will be more stimulus coming to speed up the growth slightly so that it won't touch the 6% target line in 3Q. Infrastructure projects should help too.

Upcoming trade talks and stimulus plans will help us decided if we need to revise our GDP forecast for 3Q and 4Q, but for now, we maintain them at 6.3% for 3Q and 4Q, respectively.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com