

Good MornING Asia - 16 August 2018

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Tipping point

Turkey isn't enough on its own to flip the world into a global recession, but it is not alone.



Source: Shutterstock

Turkey finds some respite, but it is not the whole story

Overnight, there have been new restrictions on Turkish Lira (TRY) FX swaps as well as efforts to bolster liquidity to keep the banking system and corporates ticking over. Combined with some assistance from Qatar in the form of a promise of \$15bn in investment, and some less spendable verbal support from Germany's Merkel, USD/TRY is trading at about 5.99, a vast improvement from the 7.32 rate reached a few days ago.

There isn't much respite from the US, which isn't even in negotiation mode over Pastor Brunson, the cleric at the heart of the political spat. He remains under house arrest in Turkey. And it doesn't look as if Turkey's President Erdogan is in any mood to row back from this issue either. Retaliatory tariffs on US food and cars probably won't do much on their own to damage the US, but it is wrong to think of this as a two-country battle, the US is engaged in trade skirmishes with a large part of the world right now. Turkey is just another name on the list.

What else? Commodities, China, Fed, USD....

At the very start of the year, optimism rode high on the synchronized global growth story. That no longer works. The US is still growing strongly. but take a look at the US Treasury yield curve, close to inversion. Expectations that US growth will persist once the fiscal stimulus wanes next year are dimming. China is still growing, but not as fast as it was, and again, expectations are rising that Chinese growth moderates further. Activity data released for July earlier this week gave this hypothesis a further nudge. Other EM countries are struggling right now. Argentina, which actually

has a worse currency performance year-to-date than Turkey, is a mess. Venezuela is a basket case. Even in our relatively insulated region of Asia, there is evidence of strain in the fragile three (Indonesia, India, Philippines), though pro-active central bank policy has done a lot to mitigate this.

The Fed is still in hiking mode. President Trump is still in trade-combative mode, and as long as this remains the case, don't expect to see the USD deviate from its current strengthening path. This not only weakens EM (and other DM) currencies but drags their short-term interest rates higher, exacerbating their problems. Don't also expect Fed Chairman, Jerome Powell, to change tack because of any of this. Despite the US indirectly running monetary policy for large swathes of the world, in particular any country with even the faintest dollar shadowing (e.g. much of the EM world) and also flipping the switch on any economy reliant on external funding (any current account deficit country), Fed policy has an almost exclusive domestic focus. That is, right up until the point where any collateral damage it creates becomes a domestic US problem. By this stage, it is usually too late.

Markets signalling trouble

From equity markets, where the S&P 500 has fallen for 5 out of the last 6 days, to bond markets, where the Treasury yield curve 2s10s slope is now only 26bp, and now to commodities, with copper plunging and now oil falling, a similar message is playing out. There is no one factor at play. But a combination and cumulative effect of many factors, Fed and US rates, Trump and trade, USD, EM flashpoints, are all adding up to something that could turn a lot uglier.

This isn't to say there is only a negative outlook. Much of what is resulting in the current bout of market pain is reversible. The Fed could signal a more cautious outlook, President Trump could make some positive overtures on trade (NAFTA, Mexico deal), China's policy stimulus could provide another lift to Asian regional demand. That said, the probability of a flip into a more negative economic equilibrium gathers by the day. We would be wise to be prepared.

Asia Day ahead

Weaker than expected Japanese exports started the Asia day on a sour note. The July trade balance has slipped back to a JPY 231.2bn deficit, rather more than the token JPY41bn deficit that had been expected. Export growth was a soggy 3.9%YoY, and imports remained strong at 14.6%YoY.

Australia's random number generator, otherwise known as the labour market report, will provide some additional market interest later on. June's 50.9K of largely permanent jobs growth looks unsustainable, and a softer figure today would seem a sensible call. But beyond that, it is hard to say anything sensible, except that whatever it does, it is unlikely to shift expectations that the Reserve Bank of Australia remains as far from any tightening as ever.

In India, the Reserve Bank (RBI) publishes minutes of the policy meeting held earlier this month. Even as inflation eased in July the accelerated currency depreciation since then will undoubtedly keep this at the top of policy worries for MPC members. Although RBI policy doesn't target the exchange rate, the intensified INR sell-off, which saw USD/INR testing an all-time high of 70 last Tuesday, will prompt the RBI to follow its counterparts in Indonesia and the Philippines on a path to more aggressive policy tightening ahead (see ['India: No respite for the rupee'](#)).

Malaysia reports GDP data for 2Q18. The consensus, which until a couple of days back, was looking

for a steady growth at the 5.4% pace in 1Q18, has finally come around to our forecast of a slight slowdown to 5.2%. Net exports displaced domestic demand as the driver of GDP growth this year, while strong exports supported manufacturing as the industry-side driver. The MYR continues to be the Asian FX outperformer this year. Steady strong growth and low inflation allow for stable policies. We consider our 4.35 forecast for USD/MYR by end-2018 subject to more downside than upside risk.

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India: No respite for the rupee

As if the global market turmoil isn't enough, domestic economic developments have been turning sour for the Indian rupee. This provides little hope for a break in the trend of the currency testing new lows against the US dollar. Prepare for more aggressive central bank policy tightening ahead



Source: Shutterstock

The Indian rupee (INR) exchange rate per US dollar surged to a record high of 70 when the Turkish financial crisis hit emerging market currencies hard earlier this week. As if the external drags on the INR aren't enough, the domestic economic data -- a multi-year high trade deficit, elevated inflation, and signs of slowing GDP growth -- haven't been any friendlier.

With an apparently shallow central bank (RBI) tightening cycle ahead, the current INR depreciation trend looks to be a prolonged one. The next challenge will be a string of state elections in the remainder of this year and general elections in 2019, which should see investors starting to add a political risk premium into local financial assets. As such, we don't rule out an aggressive central bank (RBI) policy tightening at the October meeting. Yet we see no threat to our 71.5 forecast for the USD/INR by end-2018.

\$18bn Trade deficit in July
Five-year high

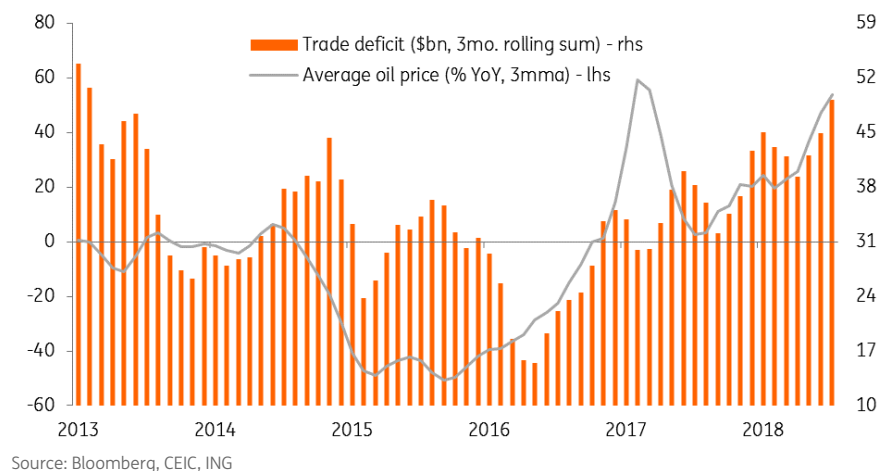
Trade deficit at five-year high in July

India's external trade deficit jumped to the highest level in five years, to \$18 billion in July from \$15.6 billion in the previous month. This was far above our forecast of a \$15.9 billion deficit, while the consensus was centred on an even lower figure of \$15.7 billion. The high trade deficit was due to import growth outweighing export growth for the second consecutive month. Imports grew by 29% year-on-year in July, beating our 26% forecast, while export growth of 14% YoY was in line with expectations.

Oil imports, with a 58% YoY surge in July, remained the main driver of total imports. Even as global oil prices stabilised around \$75/barrel in the three months through July, year-over-year oil price inflation remained on an upward trend, 52% YoY in July, causing the oil import bill to balloon. Therefore, oil has been mainly responsible for the higher trade deficit as is clear from the chart below.

The cumulative deficit in the first four months of FY2018-19 (starting April) was \$63 billion, up from \$51.5 billion a year ago. Nearly all of the widening over the year was due to oil trade. The trade balance drives the current account balance. We expect the current deficit to rise to 2.6% of GDP in the current financial year from 1.9% in the last year.

High oil price inflation is fuelling trade deficit



6.3% Core CPI inflation in July
A four-year high

Rising core inflation, slower GDP growth

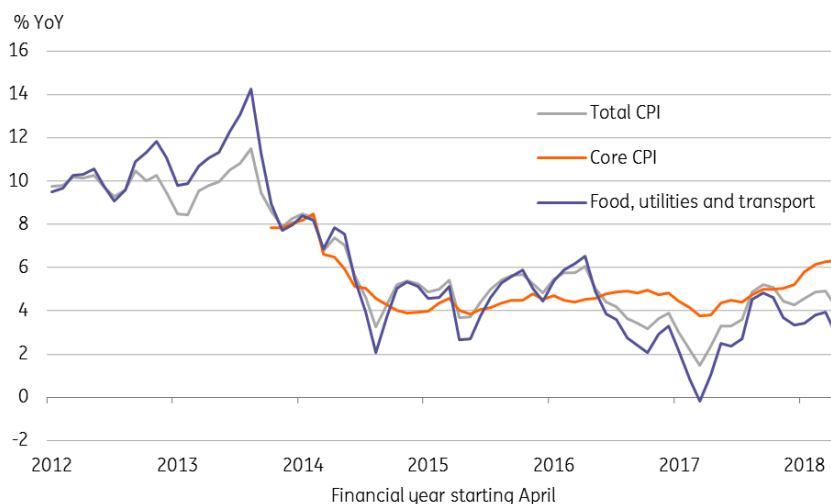
Consumer price inflation surprised on the downside in July, coming in at 4.2% YoY, while June's figure was revised down to 4.9% from 5.0%. But the headline overshadowed a steady increase in the core measure to a four-year high of 6.3%. While central bank (RBI) policymakers aren't letting their guard down against inflation, which will remain elevated due to several administrative factors apart from the high oil price, the ongoing currency weakness and higher trade tariffs will pressure inflation going forward.

And surprisingly strong industrial production data for June, with 7% YoY growth (although this is back-dated data), provides little solace. The average April-June IP growth is still slower at 5.2% from the 6.5% average in the previous three months. This foreshadows a slowdown in GDP growth in 1Q FY2018-19, not a good start to the year, the rest of which will remain exposed to greater global economic uncertainty and rising domestic political risk.

In the 2018 Article IV Consultation released last week, the IMF warned about sustained upward inflation requiring gradual monetary tightening. The Fund also warned about slower growth ahead resulting from adverse terms of trade and loss of real income to households and firms, while tighter monetary policy will hinder the recovery of credit growth and investments.

A month ago, we downgraded our GDP growth forecast for FY2018-19 from 7.2% to 6.7% ([see 'India: Downgrade of growth forecast'](#)). We now increase our inflation forecast for the year from 4.7% to 5.0%.

Rising core inflation



Source: Bloomberg, CEIC, ING

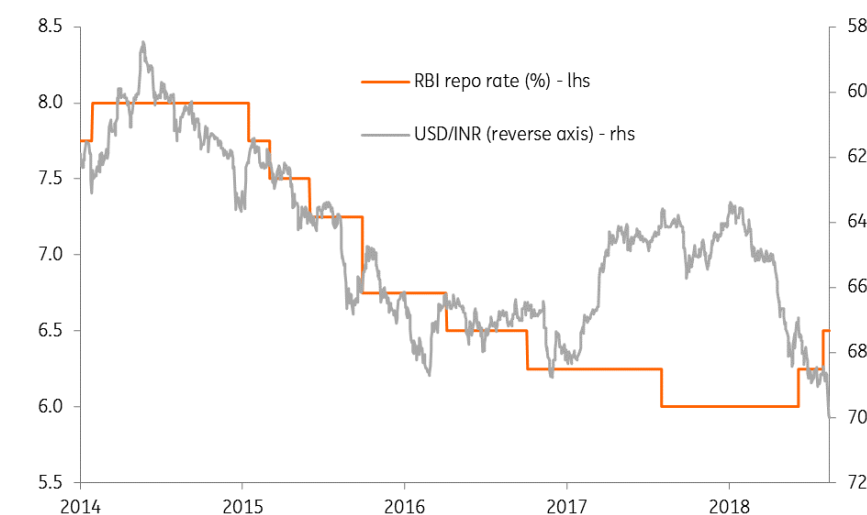
Authorities accommodating INR weakness

The INR's 8.6% year-to-date depreciation is the steepest among Asian currencies, of which 7% has occurred since April. A \$20 billion fall in foreign exchange reserves in the last four months to \$404 billion through July is a testament to the RBI's presence in the market to support the currency. This is still a sufficiently large stock of reserves, though the authorities concede that any intervention will not do much to stabilise the currency when it's due to global factors.

Even if the rupee falls to 80, it will not be a concern provided all other currencies depreciate. – Subhash Chandra Garg, secretary of India's Economic Affairs Department

And with local factors also kicking in now, it might take a more aggressive policy response to rein in INR weakness. Just as in other Asian countries (Indonesia and Philippines), a weak currency was the principal force behind two 25 basis point RBI policy rate hikes in June and August. Will the RBI follow central banks in Indonesia and the Philippines in pursuing aggressive policy tightening? Or, on the contrary, will the central bank take the currency weakness in stride as a factor required to curb imports and the trade deficit, even though this would also be inflationary. This poses a significant policy challenge for the RBI going forward.

Prepare for an entrenched RBI tightening cycle



Likelihood of more aggressive RBI policy tightening

An apparently shallow RBI tightening cycle based on current domestic economic conditions could become entrenched in the event that global currency turbulence intensifies, which remains a risk if the US delivers on its planned \$200 billion worth of tariffs on China.

While we maintain our forecast of one more 25 basis point RBI policy rate hike at the next meeting on 3-5 October, we don't rule out the RBI doubling it up. Not only that, we now add to our policy forecast a further 50 basis points of rate hikes in 2019.

Will this stem the INR weakness? Besides external and domestic economic factors, politics will be an added overhang on the currency as a string of state elections in the remainder of the year culminates in general elections by mid-2019. With investors starting to add a political risk premium into local financial assets, any relief to the currency from higher interest rates will be transitory. This should keep the USD/INR rate on the path towards our 71.5 forecast for the end of 2018.

Economic Forecast Summary

India (FY April-March)	2017	1Q18F	2Q18F	3Q18F	4Q18F	2018F	2019F
Real GDP (% YoY)	6.7	7.7	7.0	6.7	6.5	6.7	7.2
CPI (% YoY)	3.6	4.6	4.8	5.0	4.8	5.0	4.8
RBI repo rate (% eop)	6.00	6.00	6.25	6.50	6.75	6.75	7.25
3M T-bill rate (% eop)	6.15	6.09	6.46	6.80	7.05	7.05	7.50
10Y govt. bond yield (% eop)	7.23	7.40	7.90	8.10	8.30	8.30	8.60
INR per USD (eop)	63.87	65.18	68.47	70.10	71.50	71.50	69.80
Note: Annual growth and inflation forecast on financial year basis, rest on calendar year basis.							

Source: Bloomberg, CEIC, ING

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Indonesia: Central bank raises rates in quest to stabilise currency

Bank Indonesia (BI) surprised investors with a 25 basis point policy rate hike. BI has resumed tightening to stabilise the rupiah, which had fallen to its weakest level since October 2015



Source: istock

5.5%

Higher than expected

BI 7-day reverse repurchase rate

25bps hike today

BI seeks to stabilise IDR

The Indonesian rupiah (IDR) traded as weak as IDR14680 earlier this week from Friday's IDR14400. The weakness came amid a worsening in the current account deficit, which was announced last Friday to have widened to -\$8 billion or to -3% of GDP in 2Q from -\$5.5 billion or -2.2% of GDP in 1Q, and from -\$4.8 billion or -1.9% of GDP in 2Q 2017. The currency was also hit by expectations of a steady policy rate decision at today's meeting as well as the contagion effect of the slide in the Turkish Lira (TRY). Today's July trade deficit of \$2 billion, the highest in five years, indicated that the current account in 3Q could widen further as imports accelerated to satisfy strong domestic

demand.

All of this argued for BI's resumption of its tightening cycle and today's surprise 25 basis point rate hike after a pause in July. This brings BI's tightening to 125 basis points so far this year. We believe that BI could continue with its tightening cycle until some stability is achieved. Higher interest rates will eventually moderate domestic demand and imports. Import substitution efforts by the government such as using a higher palm oil-diesel blend and redirecting oil exports to the local market, and keeping the fiscal deficit at around -2% of GDP may help moderate growth and stabilise the IDR.

This combination of monetary tightening and government measures could eventually address a couple of the drivers of IDR weakness – the weak external payments condition and strong domestic demand. But these measures will take time to work through the economy, which brings the burden of short-term stabilisation onto the central bank.

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Indonesia: Trade deficit widens to five-year high

The trade balance fell back into deficit in July, posting the widest gap in five years. This together with the weakness of the current account and Indonesian rupiah could argue for a non-consensus rate hike today



-\$2.03bn

July trade balance

Widest trade deficit in five years

Worse than expected

IDR fundamentals not as strong as trade deficit widens

Import growth rebounded in July with a 32% increase after moderating in June due to the effect of Ramadan. June's imports increased by a moderate 12.7%. The recovery in imports, powered by strong domestic demand, handily beat expectations of 14% and resumes the robust pace of import demand seen in April and May.

- Non-oil imports accelerated by 29.3% in July from June's modest 8.8% increase.
- Energy imports surged 47% from the previous month's 34% annual growth. Higher energy

prices, as well as stronger demand due to higher energy subsidies, account for this vigorous import growth.

Exports in July rebounded, with a 19% gain year-on-year, which also beat the consensus forecast of 11.6%. But imports outpaced exports. As a result, the trade balance reverted to the recent trend of deficits. Catch-up from the holiday-related moderation in imports in June may partly explain the rebound. But strong domestic demand also underpinned the strength in imports while the challenging trade situation also played a role.

What it means for the central bank

The reversion to a trade deficit in July does not bode well for the current account in 3Q. The current account deficit in 2Q widened to -3% of GDP or to -\$8 billion from a 2Q 2017 deficit of -1% of GDP or almost -\$5 billion. Strong domestic demand could continue in the second half of the year and contribute to a further widening in the trade and current account deficits. We expect the current account deficit of -2.6% of GDP or a deficit of \$28 billion in 2018 from 2017's -1.4% of GDP or -\$14.5 billion. We believe that the underperformance of the Indonesian rupiah in the past week is as much related to the slide in the Turkish Lira as to the widening current account deficit. These developments could argue for a non-consensus Bank Indonesia policy rate hike at this afternoon's meeting.

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