

Good MornING Asia - 17 June 2019

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By Robert Carnell



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EM Space: Market looks to FOMC decision but strong US retail sales could stay the cut for now

- **General Asia:** Heavy global and Asian central bank calendar makes it an exciting week amid persisting headwind to risky assets from the US-China trade war. The key focus will be on the US Fed's policy statement which is widely expected to signal an easing bias. And with increased odds of the Fed easing, it's hard to see Asian central banks resisting easing pressure for too long now.
- **Thailand:** Somchai Jitsuchon, member of the Bank of Thailand's monetary policy committee signaled that the central bank policy would be data dependent. He pointed to fallout of the US-China trade war on Thailand's economy, leaving the central bank "open to all possibilities". With sub-3% GDP growth and low inflation, the case for the BoT reversing its late-2018 rate hike has become stronger, in our view. We expect a 25bp BoT rate cut at the 26 June meeting.
- **Malaysia:** Bank Negara Malaysia's Governor Nor Shamsiah Mohd Yunus anticipates increased MYR volatility ahead amid growing global uncertainty. But she also expressed confidence in Malaysia's 'proven track record in managing these shocks well'. The economy is performing relatively well compared with Asian neighbours and this supports positive

sentiment towards the MYR, in our view.

- **Philippines:** The current account deficit of \$1.2bn in 1Q19 was a fourfold widening from a year ago, thanks to the continued widening of the goods trade deficit. The BSP's report today of April overseas workers' remittances will provide a glimpse of where the current account deficit is headed in the current quarter. Widening current deficit will continue to exert pressure on the PHP although the BSP appears more dovish despite these developments and is likely to leave policy on hold on Thursday.

What to look out for: Central bank super Thursday

- Singapore non-oil exports (17 June)
- Philippines remittances (17 June)
- Germany ZEW expectations (18 June)
- Hong Kong composite interest rates (19 June)
- FOMC meeting (19 June)
- BoJ meeting (20 June)
- Bank Indonesia meeting (20 June)
- Taiwan central bank meeting (20 June)
- Bangko Sentral Pilipinas meeting (20 June)
- BoE meeting (20 June)

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Asia FX Talking: Caution ahead of Osaka G20

Although expectations of any trade breakthroughs at the Osaka G20 meeting are very low, passing this summit without trade tensions worsening substantially would be a relief, not least for the battered Korean won and the Taiwanese dollar



Source: Shutterstock

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Stability, not growth, is China's domestic focus amid the trade war

Weak Chinese exports are hitting the country's supply chains. With no deal in sight in the trade war, we're expecting the Chinese government to step up fiscal stimulus. But it's stability they're after rather than increased growth



China's President, Xi Jinping with US President, Donald Trump in Beijing, 2017

No trade deal in sight

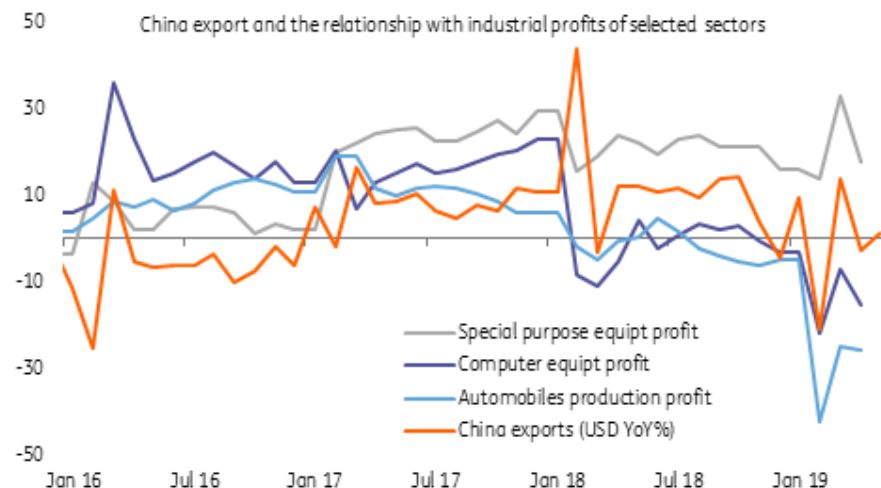
Even if President Xi and President Trump do meet on the sidelines of the G20 Osaka meeting later this month, a trade deal looks almost impossible in its current form. China is not going to capitulate under US pressure to change its laws (it's a matter of sovereignty) and the US will not accept this resistance. A meeting could take place, but we expect it will not undo the current deadlock. A good outcome would be a commitment to resume talks and result in no changes in tariffs. A bad outcome would be an immediate 25% increase in tariffs on China's remaining (some USD300bn) of goods.

How exports are hurting China's supply chain

Recent data releases highlight the deterioration in Chinese economic activity stemming from damage to export supply chains. This isn't just the effect of US tariffs but also reflects the technology war.

China exports are directly related to the profit growth of computer and special purpose equipment as these are industries highly related to export sales. It's a similar story for automobile production because of the logistic demand and also because exports affect the income of many industries that in turn affect consumption and, of course, vehicular demand itself.

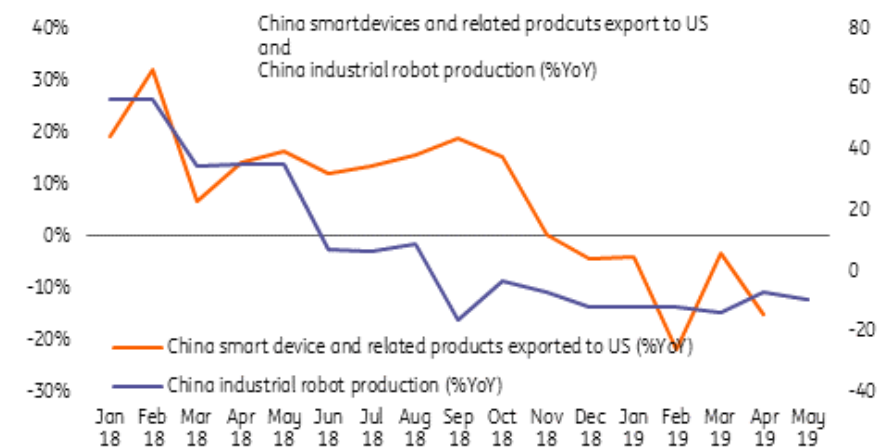
China exports and the relationship with selected industries' profit



Source: ING, Bloomberg

Moreover, China's exports of smart devices and related products to the US is highly correlated to its domestic production of industrial robots. If China faces an intensifying technology war that continues to ban the use of Chinese made smart devices and 5G equipment, other industries in the supply chain, such as industrial robot manufacturing, in China will also be affected.

A strong relationship: Chinese exports of smart devices to the US and its production of industrial robots



Source: ING, Bloomberg, CEIC

Expectations for a quick end to either of these conflicts has all but evaporated, and this is weighing

on investment intentions, not only in China but around the world. One of the consequences of globalisation is that companies are more interlinked, so problems with China's value chains can cause problems in companies in other countries.

Activity data in May shows a weakening economy

Industrial production and fixed asset investments grew slower than expected in May. Retail sales came in as expected, but that's not necessarily a good sign either.

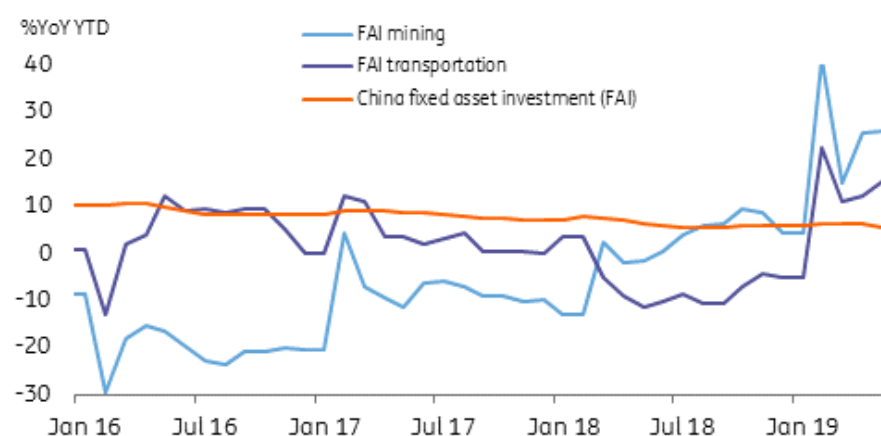
Manufacturing activities, as reflected by industrial production, grew 5.0%YoY in May from 5.4% a month ago. In some ways, this looks bad as it's even lower to the growth lows we saw in the global financial crisis in 2009-2009. But, perhaps, it looks more reasonable when you consider that exporters have expected fewer orders from exports in the coming months due to tariffs imposed on Chinese goods and the ban on using Chinese technology equipment in some countries. Industrial robot production shrank by 9.3%YoY in May after a 7.3% contraction in April.

The leverage effect on the economy from fiscal and monetary stimulus should be adequate to keep GDP growth at 6.3% in 2019

Retail sales grew 8.1%YoY YTD in May from 8.0% in April. Consumption during the long holiday supported sales. But this could be a sign that Chinese spenders stayed at home during the long holiday instead of taking leisure trips to spend in other economies. Consumers are cautious when spending. We keep monitoring items that are more volatile than others during bad times. Spending on automobiles and clothing continued to be very weak at -2.0%YoY YTD and 2.6%YoY YTD. Vehicular sales have been particularly weak due to structural changes in the market caused by technology disruption and this intensifies the current weak economic cycle. Weakening exports and a slowing manufacturing sector could derail jobs and wage growth which could well be reflected in softer retail sales data.

Investment growth was slow at 5.6%YoY YTD from 6.1%. Infrastructure related investments continued to be the sole engine of investment growth, which is the result of fiscal stimulus. Mining investment and transportation investment grew 26.1% YoY YTD and 15.4% YoY YTD in May from 25.7% and 12.3% a month ago, respectively.

Mining and transportation investments



Source: ING, Bloomberg

RRR and interest rate cuts expected to support a doubling of fiscal stimulus

China is likely to take pre-emptive action that will help shield the economy from the threat of further tariffs currently being made by US President Trump. We expect fiscal stimulus, mainly through infrastructure investments, to increase from CNY2 trillion to CNY4 trillion in 2019.

Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses

Our estimate on the size of the fiscal stimulus is more conservative than some other financial houses. One prominent pundit sees a stimulus as large as CNY7.2 trillion. We think that's overdone as we believe that although China wants to maintain a growth rate of 6.0% to 6.5%, it does not want to create another wave of over-supply production problems, similar to those after the 2009 crisis. We anticipate that the Chinese government will step up fiscal stimulus more aggressively only if and when the economy is battered seriously by the trade and technology war. That isn't happening yet. It could do, and if it does, then they can expand stimulus further. But it is too early to make such call.

During this trade and technology war, the Chinese government indeed looks for quality growth as much as quantitative growth.

- One indicator to support this view is that shadow banking activities have shrunk since the beginning of the year. Trust loans, entrusted loans and undiscounted bills fell 6.7%YoY YTD, 10.4%YoY YTD and 14%YoY YTD in May, respectively. This is the result of small private companies being able to borrow from banks so they don't need to get loans from the shadow banking sector. Though banks take on more risks it is better than having those risks piling into such a non-transparent part of the economy.
- Another indicator of quality growth is that infrastructure investments nowadays are funded by local government special bonds. Each bond funds one investment project. This makes the

use of fiscal money more visible than back in 2009 when fiscal money could get into speculation property easily and hence created ghost towns that did not have any residents.

If infrastructure investment spending is going to be doubled, the economy needs extra liquidity. We expect the PBoC to increase liquidity by cutting the targeted reserve required ratio (RRR) 0.5 percentage points in 3Q and 4Q respectively. If extra liquidity is needed, the targeted RRR cuts could become broad based. We also believe the PBoC will cut the 7D policy interest rate, currently at 2.55%, by 5 basis points in 3Q and 4Q respectively to 2.45% to drive interest rate lower. This combination of monetary easing policies should keep 7D repo around 2.5%.

The leverage effect on the economy from fiscal and monetary stimulus should be sufficient to keep GDP growth at 6.3% in 2019, which is in the middle of the official target range of 6.0% to 6.5%.

What about the currency?

First of all, monetary easing in China has no correlation with the currency. As such we don't expect yuan depreciation from further monetary easing.

However, though we agree that USDCNY at 7.0 is just a “round number”, it is too late for the PBoC to change market concerns that USDCNY crossing 7 will create chaos. At the end of 2016 and in October 2018, the USD/CNY didn't cross the 7 handle. The perception in the market that USDCNY 7.0 is a big deal has been consolidated by the PBoC.

Currently the Chinese economy is facing headwinds from the trade and technology war. It is even more difficult for the PBoC to allow the USDCNY to cross 7.

It is equally difficult for the yuan to appreciate as that will create an impression that the PBoC is appeasing the US administration.

We therefore forecast USDCNY at 6.90, 6.95 and 6.90 by the end of 2Q, 3Q and 4Q19.

USDCNY: We're close to 7, but unlikely to pass it



Source: ING, Bloomberg

As of 14th June 2019

China	2018	1Q19	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (%YoY)	6.6	6.4	6.2	6.3	6.3	6.3	6.2
CPI (%YoY)	2.1	1.8	2.5	2.6	2.6	2.4	2.5
PBoC 7D reverse repo rate (% eop)	2.55	2.55	2.55	2.50	2.45	2.45	2.40
10Y govt. bond yield (% eop)	3.30	3.07	3.20	3.00	2.95	2.95	2.85
CNY per USD (eop)	6.88	6.71	6.90	6.95	6.90	6.90	6.75

Source: ING

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China: Expect a long march

We think the authorities will increase fiscal stimulus, as well as cut interest rates and the reserve requirement ratio (RRR) to support growth, in what is becoming a difficult environment for Chinese companies in the trade and technology sectors



Source: Shutterstock

China-US tensions have spread beyond trade

China-US trade tensions deteriorated quickly after President Xi requested dignity in the trade talks, and both sides increased tariffs on each other. The US raised tariffs from 10% to 25% on the existing \$200 billion goods, and China has increased tariff rates to 10% to 25% on \$60 billion goods imported from the US.

Away from trade, US added Huawei, the Chinese pioneer in 5G, into its 'entity list', which deters US companies from buying and selling goods and services with Huawei. The Chinese government reacted by creating its 'unreliable entity list' and may reduce exports of rare earths. Further, the Chinese government interviewed multinational companies that have businesses in China. The tension between the two countries has extended from trade, technology to broader-based businesses.

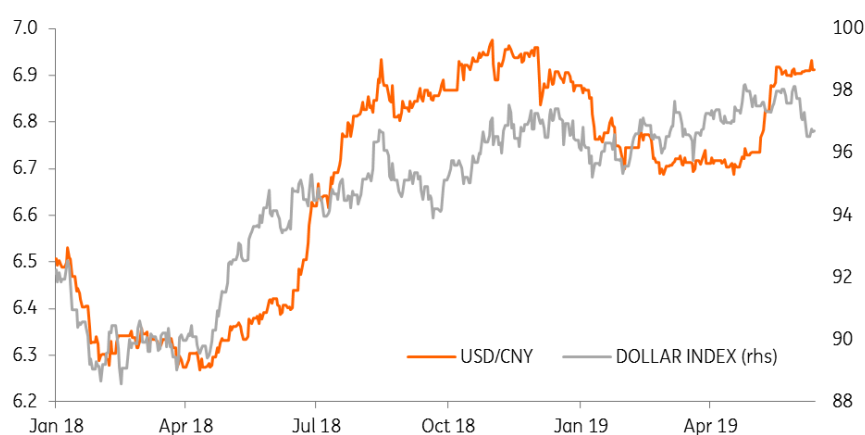
President Xi calls this increase in tensions the 'new long march'. In early June, China signalled that it will increase its fiscal and monetary stimulus to support the economy during this new long march.

China is expanding infrastructure investment further

On fiscal stimulus, the government has issued a document that encourages the issuance of local government special bonds to fund infrastructure projects, and it also welcomes financial institutions to invest in those instruments. The planned amount of issuance is around two trillion yuan. With the help of financial institutions, this amount can be leveraged to around two times, according to our estimates. That means infrastructure investments could increase to around four trillion yuan.

Together with tax and fee cuts of another two trillion yuan, the fiscal stimulus package may total six trillion yuan.

USD/CNY has diverted from the dollar but yet to pass 7.0



Source: Bloomberg, ING

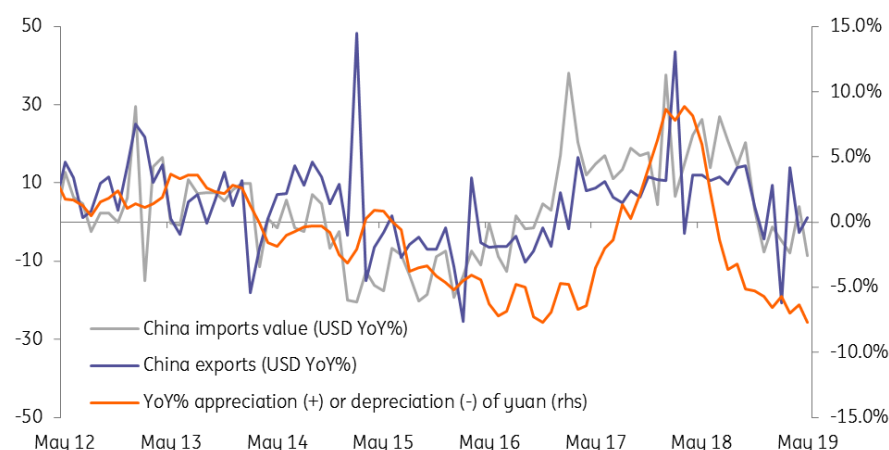
China is prepared to cut interest rates and the reserve requirement ratio

On monetary easing, the PBoC governor, Yi Gang, has claimed that the central bank has many tools to inject liquidity in the market. These include cuts in interest rates and reserve requirement ratio (RRR).

Combining fiscal and monetary easing capacity, China should be able to withstand a long pause in the trade negotiations while maintaining GDP growth above 6%, which will largely be stimulus-driven, unlike normal growth driven by business activities determined by market forces.

Yi Gang also mentioned briefly that no particular level of the USD/CNY is more important than other levels, signalling that the 7 handle of the USD/CNY is not a boundary set by the PBoC. But we still don't believe the PBoC will take the big risk to allow USD/CNY to pass the 7.0 handle. Last year, the PBoC didn't allow the USD/CNY to pass 7.0, because the central bank worried that it would create market chaos. Today, with the background of a trade and technology war, the central bank may be even more cautious not to let the exchange rate create chaos in other asset markets. Moreover, as we show in the chart, a depreciation of the yuan has no positive impact on trade.

Yuan depreciation hasn't helped trade



Source: Bloomberg, ING

We have revised our FX forecasts

As a result, we have revised the USD/CNY and USD/CNH exchange rates to 6.90 by the end of 2019. We also believe the central bank will cut 7D policy rate twice, each time by 5bps, with cuts the targeted as well as broad-based RRR by two times each.

We maintain our GDP forecasts at 6.2%YoY in 2Q19 and 6.3% for 2019, as we believe that the tough stance on trade will be balanced by stimulus measures.

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