Good MornING Asia - 19 January 2018

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By Robert Carnell

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Coin toss

Will they? Won't they?

There used to be a time when being an economist meant looking at economic data, building a model and coming up with a moderately informed view on future events. That was before politics became the driving force behind economics and markets. Now, we are confronted, almost daily it seems, with a never-ending list of binary events, most of which have about a 50:50 chance of happening. We are still asked to provide a view. It just happens that most of these views are worthless. Moreover, forecasters in the private sector face various unspoken challenges in predicting catastrophe - that could form the basis of a PhD thesis in forecast bias.

The US government shutdown is just such a binary event, affecting not just US markets, but global markets including those in Asia. The split of Republican and Democrat voters on both sides of the argument makes this close to a 50:50 call, especially with some Conservative Republicans not convinced in signing up for a continuation bill and some Democrats likely to weigh the costs of shutdown in terms of voter sentiment more negatively than letting it pass.

As we wrote yesterday, markets are caught up in this. Risk sentiment has roughly reversed since then, with equity markets and the USD in full retreat. One tweak, however, is that bond markets are still selling off, as another factor has grabbed investors attention.

2.08%

Breakeven inflation rate on 10Y zero coupon US Treasury bond

Inflation - It's alive!

The negative correlation between stocks and bonds has broken today, with both selling off - the new factor, it seems, is new-found respect for inflation risk, as investors make a rush for inflation protection. This is illustrated in the breakeven rate for 10Y US Treasuries, which is spiking higher, even as the term premium remains in negative territory. If anything, this inflation expectations spike is likely to encourage the FOMC to deliver more tightening, not less. So for a time at least, this could become a self-fulfilling move, with rising yields pushing thoughts of rising short-term rates.

Also, it transpires that much of the offshore earnings talked about following recent tax reform, is parked in the US Treasury market, not offshore in any real sense at all (maybe only in an accounting sense). This too has raised suspicions that it is in Treasury yield space, not FX space, that we may see the biggest market effects of this policy.

Of course, by Monday, all this may have swung back again if a deal is reached. Do you still want a forecast? Heads or tails?

Break-even inflation rate for 10Y US Treasury

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Source: istock

6.9% China GDP 2017

Forecast 6.7% in 2018

Middle class consumption and high-tech manufacturing drive growth

China real GDP grew 6.8% year-over-year in the fourth quarter and 6.9% in 2017, beating our forecasts at 6.7% and 6.8%, respectively. The discrepancy could come from December's lower growth imports, which was partly a result of tighter solid waste import restrictions, and also from lower inflation in 2017 (1.6%) compared to 2016 (2.0%).

The biggest driver of growth was the consumption of goods and services, fuelled by a 9% rise in disposable income. Spending on cosmetics was 13% higher, healthcare at 11%, and housing at 9.6%. There was a small downward surprise on retail sales in December, at 9.4%YoY versus our forecast of 10.4%. This came from the low growth of automobiles at 2.2% from 14.4% Dec

2016.

Fixed asset investment grew 7%YoY in 2017, in line with our forecast. As expected, most of the growth came from state-owned enterprises (10%YoY) as infrastructure investment was the main engine, rising 19%YoY. Local projects rose 7.7% while central projects fell 5.7% in 2017. These highlighted the strong demand for local infrastructure for water management and other facilities.

Industrial production grew 6.2%YoY in Dec 2017, higher than our forecasts of 6.1%.

Overall, manufacturing was balanced by the robust growth in new sectors designated by government policies. Specifically, China produced 68% more industrial robots and 50% more new energy cars in 2017.

All this points to the fact that China is moving towards a consumption based economy and is expanding high-tech in the manufacturing sector.

2018 could be another strong growth year

With projected GDP growth of 6.7%, 2018 could be another good year for China, supported by consumption of goods and services and infrastructure investments. We expect the manufacturing of high-tech products and parts to grow by more than 50%. That should support the loss of production from overcapacity cuts in non-ferrous metals, shipbuilding and building materials.

Financial deleveraging reform poses a risk

Financial deleveraging will present opportunities and risks in 2018. Interest rates could be pushed up by tighter liquidity. We believe that financial regulators would need to handle this very carefully because banking and non-bank financial sectors are intertwined via wealth management products and other shadow banking products, and the financial sector is related to corporate and household credit as well as investments.

Our view is that a policy rate hike should be mild regardless of the momentum from the Federal Reserve. We expect three hikes, the same as the Fed, but the Chinese central bank would likely make smaller steps, with hikes in five basis point increments. The Yuan will continue to appreciate mildly at 3% to 6.30 to attract net capital inflows.

We also think that the fiscal deficit would increase from the target of 3-4% in 2017 % to 4-5% in 2018. Although government debt is not an imminent risk in 2018, the accumulation of government debt could become a concern after a few years.

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