Good MornING Asia - 2 August 2019

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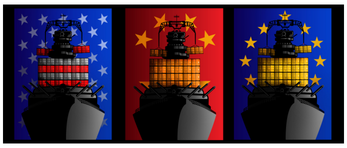

China

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Aerial view of Kwai Tsing container terminals Hong Kong, China

New tariffs not a total surprise...

Although I confess to being totally surprised at the speed with which US President, Donald Trump, has levied an additional 10% of tariffs on $300bn of Chinese exports, the scenario of a further intensification of the trade war before an eventual deal/truce to coincide with the Presidential Election, was actually our house base case, set several months ago and documented by our trade team in conjunction with the views of our US and China economists.

However, in recent weeks, the window for a further intensification of the trade war seemed to be narrowing, and I admit that I haven't been pushing this view very forcefully. Call it a base, but low conviction assumption amongst many permutations of the trade war that were possible. But in the end, it seems to have been remarkably prescient.

The reaction from China has been fairly predictable. They have apparently already cancelled 14,700 metric tons of US pork in the fallout from the latest announcement, and USDCNY has spiked a little higher. I guess it could go a little further yet. No point in trying to claim the moral high ground on the currency if you are going to get hit by tariffs anyway. That's one way of looking at it.

Chinese growth already looked under strong pressure, and export-oriented private-owned manufacturing companies woes were being offset rather than shielded, with infrastructure spending growth. The GDP result may, as a result, have been modest so far, but this is an "apples and oranges" comparison, and apart from a few Chinese officials, whose success probably does derive from hitting GDP and other targets, this isn't particularly reassuring to the international investment community. As recent PMI data have shown, China is really beginning to open up a two-speed economy.

Its early days in this and not my call in large part to determine what now happens to economies and markets.

What now?

Its early days in this and not my call in large part to determine what now happens to economies and markets. However, in an early bid to consider what may now transpire, our Greater China Economist Iris Pang, has some interesting thoughts in a note she knocked together quickly this morning. I had anticipated this morning's note waffling about how tonight's non-farm payrolls release would either cause markets to side more with the Jerome Powell view of a mid-cycle correction and see further yield curve flattening. But that's all for the birds now. Payrolls, schmayrolls! If you still care, please read this from James Knightley.

Today, 2Y US Treasury yields are down 14.4bp to 1.730. Fed funds futures have moved aggressively to price in more easing. 10Y yields have also dropped sharply, and are now 1.89%, though a smaller drop than at the front end. Stock markets are deep in the red. I expect more of this in the coming days.

Markets were hoping for a string of easing from the Fed. Be careful what you wish for because if that is what we will now get, we will get it for good (that is to say "bad") reason. And risk assets won't like that backdrop, nor will Asian FX if today's movements are anything to go by.

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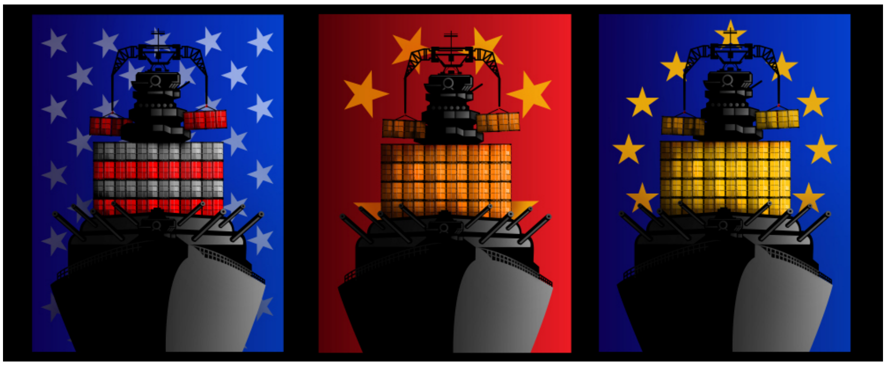
How will China retaliate against higher tariffs?

China is facing a new round of 10% tariffs on $300 billion of goods exported to the US to be effective on 1st September. How China retaliates will determine the tariffs' impact on both economies



Source: Shutterstock

US raises tariffs on China

The US is to levy a further 10% of tariffs on the remaining $300 billion of goods it imports from China. The tariff will become effective on 1st September. This escalation of the trade war comes hot on the heels of trade talks that ended with no progress on 31st July after only half a day of discussions, but which were described as "constructive" by Director of the US National Trade Council, Peter Navarro.

How will China retaliate and impacts on the trade war?

There are a few things that China can and probably will do in retaliation to the US' new round of tariffs:

1. **Announce China's unreliable entity list**. This could exclude some US companies from doing business with Chinese companies. The unreliable entity list is said to be announced soon. The market has been guessing which US companies will be the first to be included in the list, and thereby shut out from doing business with China.
2. **Prohibit exporting "rare-earth" materials to US** and related companies that use them in the production of US products (very important in a lot of hi-tech/electronic products). This could halt, or at least slow some US production.
3. **Increase tariffs on US goods**. Though China imports far less from the US than the US imports from China, China could still raise tariff rates further - conceivably beyond 25%. China already raised tariffs from 10% to 25% on $60 billion of US goods on 1st June.

These possible sources of retaliation from China would, of course, escalate the trade war further.

Impact of US tariffs and China retaliation on the Chinese economy

For the 10% tariffs on the rest of the $300 billion goods imported from China, this involves electronic devices.

The 10% tariffs on $300 billion goods will hurt some US tech product companies, which have so far been shielded from the tariffs. US companies could conceivably shift value chains away from China in an attempt to limit the blow of tariffs on their margins. Over the medium term, this is certainly possible, but in the short-run, this is unlikely to be practical given the highly specialized nature of some of these products.

Rare earth export embargoes will heap further pressure on US tech companies. Though they may have some inventories of rare earths, these probably won't last long. Alternative sources of rare earth materials are being developed to try to lessen dependence on China which is currently the source for 80% of global rare earth supply. But this will also take time. In the short run, the alternatives are either paying a much higher price to gain access to rare earth supplies or going without altogether.

Impact of possible China tariffs

The impact on China of imposing higher tariffs on the US is similar to the impact on the US of raising tariffs on China. Both actions weigh on margins, turnover and the profitability of domestic industry. One way to alleviate the damage from tariffs would be to import more from other economies. Europe is a likely option (for both the US and China) but we expect that this will not work for all goods, and supply constraints may also limit the degree to which this will be possible.

In short, China's importers, producers and consumers of US imported goods will pay higher prices in the future unless alternatives are found.

Using all the retaliation methods

We expect China to use all the retaliation methods described above, but not all at once. We believe China will deliver each retaliation methodically, and deliberately, one by one.

We believe China's strategy in this trade war escalation will be to slow down the pace of negotiation and tit-for-tat retaliation. This could lengthen the process of retaliation until the upcoming US Presidential Election. It won't have escaped the authorities in China's attention that a full-blown trade war is unlikely to help President Trump's chances in the election.

Is this election interference? Well as they say, all's fair in love and (trade) war.

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Asia week ahead: Packing an easing punch

Central bank policy meetings dominate next week's Asian economic calendar. Some of them have signalled a pause in easing, some are continuing to cut rates further, and some are likely to embark on that path. GDP and trade releases are the other highlights, while China's monthly data dump begins

Source: Shutterstock

On hold RBA and RBI

Of five Asian central banks reviewing their monetary policy next week, two have signalled a pause in their easing cycles. The central banks of Australia (RBA) and India (RBI) fall into this category. The RBA has already cut rates in June and July.

> *...we will be closely monitoring how things evolve over the coming months. Given the circumstances, the Board is prepared to adjust interest rates again if needed to get us closer to full employment and achieve the inflation target. RBA Governor Philip Lowe*

We think data this week showing improved inflation in 2Q19 has taken the pressure off the RBA for a third cut. At 1.6%, inflation is still far from the RBA's 2.5% policy goal, though the bank is also waiting to give recent fiscal policy a chance to achieve the target.

Well ahead of the curve, India's RBI has eased in all three meetings so far this year, cutting by a total of 75 basis points. But according to Governor Shaktikanta Das, the bank has done even more than that. He considers the very shift to an easing stance at the June meeting, from a neutral position, to be worth an additional 25bp of stimulus on top of pumping the system with 'surplus liquidity'. We read this as a hint that the RBI has done enough.

> *Effectively, the rate cut has been 100 basis points if you take into account the change in stance. ... Parallel to that we have also ensured surplus liquidity in the system," RBI Governor Das*

With the economy facing upward inflation pressure, albeit gradually for now, and growth remaining supported around 6%, still among the fastest in the world, we don't think the RBI will want to risk any policy errors by providing excessive stimulus. We don't mind being outside the consensus again this time, but we expect the RBI to remain on hold next week, while the consensus is looking for another 25bp cut.

Australian 2Q19 CPI takes pressure off Reserve Bank

More easing by RBNZ and BSP

Among those likely to cut rates next week are central banks of New Zealand (RBNZ) and of the Philippines (BSP) – a second rate cut by both this year. We aren't alone; the consensus is also suggesting 25bp rate cuts by both banks. After cutting rates by 25bp in early May, the RBNZ paused at the late June meeting. The market-implied probability for another rate cut next week stands at 92%.

In the Philippines, the BSP policy announcement comes on the day the country's Statistics Authority unveils GDP figures for 2Q. We expect growth to have stayed below the 6-7% official target for 2019 in the last quarter (ING forecast 5.8% vs. 5.6% in 1Q). Having hiked by 175bp in 2018, the BSP has plenty of policy space to ease, as long as it's supported by falling inflation and stable exchange rates. And we have the best of both worlds - inflation has been falling steadily after peaking at 6.7% in Sep-Oct 2018, and the PHP has been among Asia's top performers this year. The July CPI data just days ahead of the BSP meeting will be timely information for policymakers.

Philippines: The BSP Hawk-Dove meter

BoT starting easing, hopefully

The key question of the week is whether the Bank of Thailand sheds its hawkish bias and becomes part of the global easing wave. Our answer is 'Yes'. However, that's not quite evident from a still solid consensus for stable BoT policy.

With growth poised to slow further, 2019 is shaping up to be the worst year for the economy in the last five years. Inflation has been under control (latest 0.9% in the year through July) and the authorities are worried about runaway currency appreciation hurting the economy even more. The central bank's latest measures to curb short-term inflows haven't been effective. An aggressive policy rate cut could be helpful here, though judging from the consensus we might not get it. Here again, we don't mind being the odd one out in our forecast of two 25bp BoT rate cuts this year.

Thailand: Downgrading GDP growth forecast

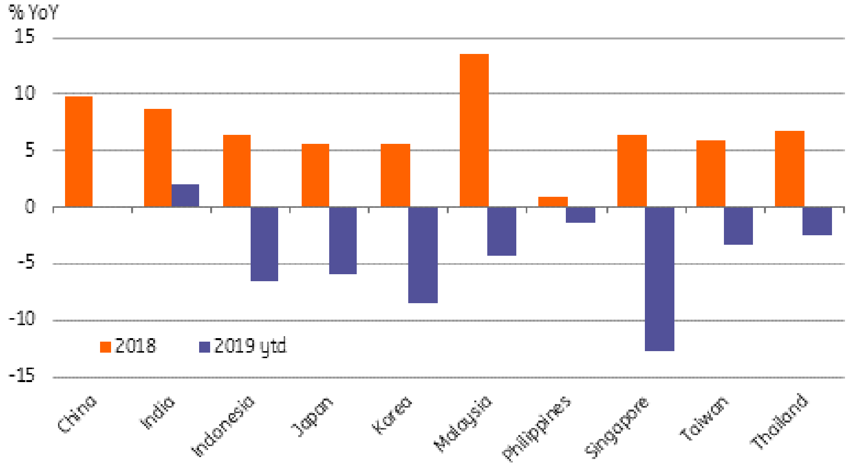
China data and more

Of all the China data due next week, trade figures will be under the most scrutiny as we try to gauge the impact of trade wars. And just as in recent months, we aren't expecting anything too bad just yet.

Despite the trade war, China's exports remain an outperformer in Asia with virtually flat growth in the first half of the year compared to heavy declines in other parts of the region. Economies which are heavily reliant on electronics exports (Korea and Singapore) have been hit hard in the current export downturn. But a second surprising comeback of Taiwan's exports (also largely electronics driven) could be a hopeful sign of a bottoming in the global electronics slump. Consistent with the consensus, we anticipate a second consecutive month of positive export growth for Taiwan.

Taiwan: weak PMI not in line with strong GDP

Asian export performance



Source: Bloomberg, ING

Asia Economic Calendar

Country	Time	Data/event	ING	Survey	Prev.
		Monday 5 August			
India	0600	Jul Nikkei Services PMI	49.9	-	49.6
Indonesia	-	2Q GDP (QoQ/YoY%)	5.1	4.2/5.0	-0.5/5.1
		Tuesday 6 August			
Korea	0000	Jun Current account balance (US$bn)	6.5	-	4.9
Philippines	0200	Jul CPI (YoY%)	2.4	2.4	2.7
Taiwan	0900	Jul CPI (YoY%)	0.9	-	0.9
	0900	Jul WPI (YoY%)	-1.9	-	-1.9
		Wednesday 7 August			
China	-	Jul Forex Reserves (US$bn)	3110.8	-	3119.2
India	0715	RBI policy decision (repo rate, %)	5.75	5.50	5.75
Malaysia	0800	Jul 31 Forex reserves- Month end (US$bn)	-	-	103.3
Philippines	0200	Jun Exports (YoY%)	1.1	-	1.0
	0200	Jun Imports (YoY%)	-2.6	-	-5.4
	0200	Jun Trade balance (US$mn)	-3255	-	-3275
	-	Jul Forex reserves (US$bn)	-	-	85770.8
Taiwan	0900	Jul Exports (YoY%)	1.9	-	0.5
	0900	Jul Imports (YoY%)	1.5	-	6.6
	0900	Jul Trade Balance (US$bn)	2.4	-	3.6
Thailand	0805	Benchmark Interest Rate	1.5	1.75	1.75
		Thursday 8 August			
China	-	Jul Trade Balance (US$bn)	37.0	-	51.0
	-	Jul Exports (YoY%)	-2.6	-	-1.3
	-	Jul Imports (YoY%)	-8.1	-	-7.3
Philippines	0300	2Q GDP (QoQ SA/ YoY%)	-/5.8	-	1.0/5.6
	0900	Overnight Borrowing Rate	4.25	-	4.5
Singapore	0600	Jun Retail sales value (MoM SA/ YoY%)	1.2/-2.2	-	-2.2/-2.1
		Friday 9 August			
China	0230	Jul CPI (YoY%)	2.7	-	2.7
	0230	Jul PPI (YoY%)	-0.1	-	0.0
	-	Jul Money supply (M2) (YoY%)	-	-	8.5
India	1300	Jun Industrial production (YoY%)	-	-	3.1
Malaysia	0500	Jun Industrial production (YoY%)	5.5	-	4.0

Source: ING, Bloomberg, *GMT

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Taiwan: weak PMI not in line with strong GDP

Taiwan's manufacturing PMI tells a story of shrinking activity due to weaker demand for electronic products. But GDP growth in 2Q19 shines. This is a usual phenomenon for Taiwan, so how long will it last?

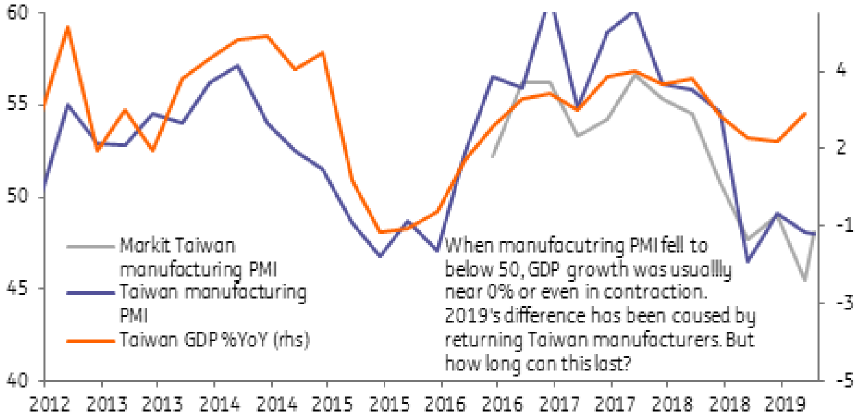
Source: istock

Manufacturing PMI stays below 50

Taiwan's official PMI fell to 48.0 in July from 48.1 a month ago though Markit manufacturing PMI edged up to 48.1 from 45.5. In any case, both figures show manufacturing activities shrinking in July. And that's highlighting weak export demand. The new export orders PMI sub index came in at 46.8, falling from 48.1. Domestic demand for manufacturing parts and products also shrank in July. New orders fell to 48.2 from 48.7.

All in all, Taiwan's manufacturing sector continues to contract.

How can GDP shine when manufacturing activities contract?



Source: ING, Bloomberg

Why GDP could have jumped

GDP growth jumped to 2.41%YoY in 2Q19 from 1.71%YoY in 1Q19.

Manufacturing makes up 28.95% of Taiwan's GDP. So, just why is there this contrast between manufacturing and far better GDP figures? The government explained that the gap was filled by investments of manufacturers returning to Taiwan from mainland China. Capital goods imports increased by 21.8%YoY in 2Q. The government estimated the capital formation makes up 1.23% of the 2.41% GDP growth.

It seems that investments by the Taiwan manufacturing "returners" has also supported consumption. Consumption grew 1.57%YoY in 2Q. According to the press report, there were 100 Taiwan enterprises returning to Taiwan, investing TWD500 billion in total.

Is this too good to be true?

We are not particularly optimistic about Taiwan's economic situation.

1. The investment spree of Taiwan's "returning" manufacturers is a one-off event. There will not be an unlimited flow of Taiwan manufacturers moving back to Taiwan from the mainland
2. There are reports that Taiwan is not prepared for the Taiwan returners'. The famous five insufficient factors are the problems faced by those "returning" manfuacturers, notably a lack of water, electricity, land, workers and talent. It takes years to build water and electricity capacity. Even when the government can provide land, these lands should have the basic infrastructure around them, for example, highways linking to ports and airports. Moreover, Taiwan's unemployment rate is not high (latest at 3.74%), a sudden increase in demand for workers will push up wages and can become an inflation issue.

The 2Q number pushes up our GDP forecast

Even that we think the "returning" manufacturers only provide a one-off boost to Taiwan, we have to revise our GDP forecast as the GDP in 2Q19 at 2.41%YoY was much higher than our forecast of 1.4%YoY, we revise the full-year GDP forecast to 2.08%.

We keep the forecasts on 3Q and 4Q unchanged at 2.0%YoY and 2.2%YoY, respectively, as we believe the investment spree is one-off and the PMI reflects the fact that demand for electronic products is still weak.

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