

Good MornING Asia - 2 July 2018

The euro is swinging around on the spat between German Chancellor Angela Merkel's CDU party and their Bavarian CSU coalition partners - a weaker euro typically means weaker Asian FX. We are revising our USD/CNY forecast to 7.0 by the end of 2018

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By Robert Carnell



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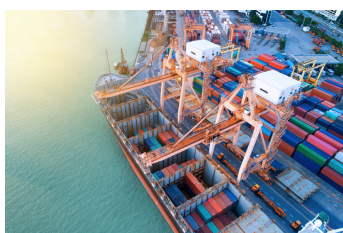
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Source: Shutterstock

It's miles away, but the German political tussle could be important in Asia

One of the biggest selling jobs I have is to persuade a US-focussed Asian clientele that they also need to keep an eye out on Europe. Right now would be a very good time to do that. The political argument between Germany's Chancellor, Angela Merkel, her CDU party and the coalition CSU party over immigration has reached new heights, with the CSU's Horst Seehofer (Interior Minister under the coalition) threatening to resign over the deal struck by EU leaders at the end of last week. This deal, which would facilitate the removal of immigrants back to their country of arrival in the EU, does not seem to have gone far enough for some of the CSU leadership, including Seehofer.

At the moment, the CDU are overwhelmingly backing Merkel, and that is providing the EUR with a little support. But if that shifts and the coalition looks threatened, then as well as the EUR, which would soften abruptly, at stake would be Merkel's chancellorship, the Schengen border arrangement, some might even say the future of the EU itself (though that might be going a little far).

So what? Well if that happens and the US dollar strengthens by default, then Asian FX will be unilaterally weaker, inflation will rise, and central banks will need to take a more hawkish rate stance, weighing on domestic demand. Right now, that is the last thing the global market needs.

So, don't ignore Europe!

Worth also giving the Mexican elections a quick squiz

I am going well off-piste when I say that Asian investors might want to give the Mexican elections a once-over too. With the votes not yet counted, newswires seem to believe that the left-leaning Andres Manuel Lopez Obrador will win a landslide.

Markets are anxious. Left-leaning politicians are regarded as less market-friendly than right leaning ones. Moreover, Obrador has apparently taken a tough line on US trade policy and NAFTA negotiations. Opening up trade wounds with the US at this juncture seems like pouring fuel on the already smoldering trade fire. This could provoke a more generalized risk-off sentiment in financial markets. Not good for Asian FX.

Tankan - not so cheery now

Japan's Tankan survey still commands some interest in markets, given the choppiness of the GDP data, and its message today was a modestly negative one. I say modestly because although the headline index for large manufacturers was down more than expected, the 'outlook' index for the same group of firms actually ticked up a point (not clear why). Also, the capex intentions were also stronger than had been expected, though this is typically a back-weighted index, so it was always likely to rise to some degree as we move through the year. If nothing else, this data suggests that current momentum is stronger than was previously thought, though coming off faster. Smaller firms too and the non-manufacturing sector also held up better than the headline index. Though overall GDP growth in Japan is still tightly linked to the manufacturing production cycle, and this is clearly weakening.

Asia week ahead

After last week's Bank Indonesia 50bp hike, which could provide some (though perhaps short-lived) support to the rupiah today, there isn't too much central bank action in the region this week. Australia's Reserve Bank is thought unlikely to hike rates at all this year, so we doubt we will get so much as a hint at policy direction from them, though, following last week's RBNZ suggestion that rates can go down as well as up, there is always a risk their bigger neighbour might follow suit.

The week is otherwise dominated by PMI data (today) which could indicate the degree to which trade tensions are already hurting in advance of Friday's implementation of tariffs by China and the US (Canadian levies took effect on Sunday, whisky and jam...). Inflation data is the other big print this week. Today delivers Thai and Indonesian inflation, later in the week, Taiwan, Korea and the Philippines all release their price data. A soft print on the Indonesian figure (was 3.23% in May), may help BI to persuade markets that its hikes are working...

Korean trade figures released over the weekend weren't brilliant, but they weren't too bad either. The 0.1%YoY decline in exports overstates the downside for a choppy figure that seems in levels terms to be growing slowly, after flattening out through the second half of 2017 and early 2018. Imports are rising more strongly, and the trade surplus will likely narrow over the rest of the year if this pattern continues. That isn't particularly worrying if the import story reflects stronger domestic demand. Although that story could do with a bit more support to become convincing.

Author

Robert Carnell

Regional Head of Research, Asia-Pacific

robert.carnell@asia.ing.com

Why we're revising our yuan forecast down again

We are revising our USD/CNY forecast to 7.0 by the end of 2018. But there's no panic in the market and we don't expect a repeat of August 2015



Policies could attract foreign investments, reduce outflow worries

Our [previous argument](#) for a slight yuan depreciation was based on the concern that a weaker yuan could lead to massive capital outflows, which would then push the yuan down even further, resulting in a vicious cycle.

But new policies to open up the market for foreign investments reduce the risk of outflows. These policies could also help to offset any outflows that do occur as a result of the weaker yuan.

New policies cover a whole range of sectors including agriculture, rare earth, automobiles, shipbuilding, aviation, railway, shipping services, surveying and financial services. The scope is not only larger than expected, it targets sectors affected by tariffs. Foreign companies facing tariff risks could move production to China to avoid tariff hurdles.

These measures, together with potential inflows from more A-share inclusion into MSCI and China Depository Receipts (CDR) in 2H18, have led us to reassess our outlook for capital outflows. We

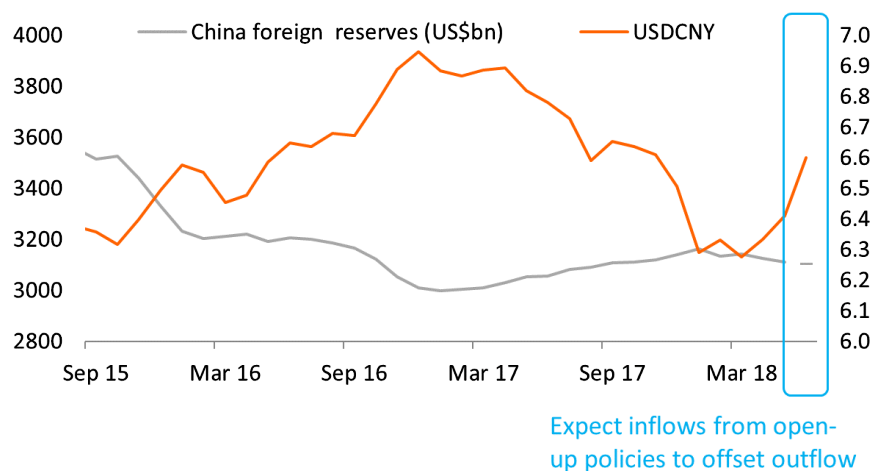
were overly pessimistic.

Limiting offshore dollar bond issuance signals further yuan weakening

It is reported in the media that China is going to restrict offshore dollar bond issuance to no less than 365 days. The objective is to reduce repayment risks as the yuan weakens against the dollar over 12 months' time.

We see this as a signal that the central government is increasingly prepared for a weaker yuan.

Foreign reserves may fall only mildly even as yuan depreciation speeds up



Source: ING, Bloomberg

Reintroducing counter-cyclical factor only if market panics

The central bank may reintroduce the counter-cyclical factor in the currency's fixing formula only if onshore and offshore yuan intraday activities signal panic in the market. The counter-cyclical factor would limit the volatility of the yuan at the start of the day. After the reintroduction of the counter-cyclical factor, intervention via the derivative market or the spot market would be likely to avoid further yuan depreciation.

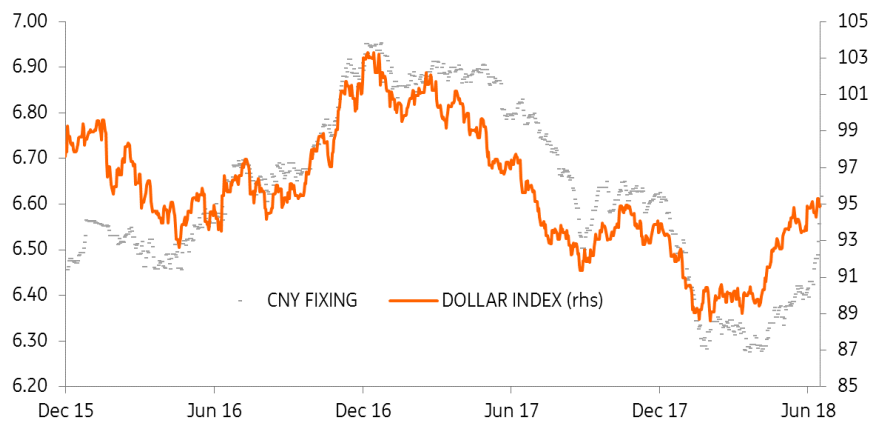
The yuan is the only a shield in a trade war

Yuan depreciation can't be described as a weapon in a US-led trade war, even if the currency were to fall by more than 7% per year.

Tariffs of 10% to 25% on \$450 billion of Chinese goods have a larger impact than just the tariff amount itself. They would reduce trade flows overall. Exporters wouldn't just see a 'mere' 10% to 25% reduction in profit margins, they could miss an entire export order.

A weaker currency would, at most, be a shield, safeguarding wider damage from a trade war and the hurdles faced by Chinese companies' operating in US.

Yuan fixing and dollar index



Source: ING, Bloomberg

Forecasting USD/CNY at 7.0

We are revising our USD/CNY forecast from 6.60 to 7.0 by the end of 2018, which is near a historical high since reform. The central bank's attempt to liberalise the yuan on 11 August 2015 drove USD/CNY to 6.9649 in 4Q 2016.

We think that this time USD/CNY at 7.0 won't create panic:

- 11 August 2015 was a crisis caused by the central bank. Today's depreciation is market-driven, reflecting the risks of a trade war. This implies that the central bank is allowing market forces to dictate the speed of the depreciation when there is room to do so.
- Since the escalation of a trade war and announced investment hurdles, China has allowed the yuan to weaken against the dollar, even when the dollar index itself has weakened. This confirms our view that yuan weakness reflects trade war risks.
- We hesitate to predict that the USD/CNY will surpass 7.0 because that could lead to market panic.

Indonesia: A surprise 50 basis point rate hike

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5.25%

Higher than expected

BI 7-day reverse repurchase rate

Market expected only a 25 bps hike to 5%

Precipitous slide of IDR required a more aggressive BI response

Bank Indonesia, under the leadership of the new BI Governor Perry Warjiyo, responded decisively to the urgency of the situation. BI has acted pre-emptively to stabilise Indonesia's financial markets in general and the Indonesian rupiah in particular. IDR has fallen by as much as 4.4% from the highs posted early this month following an out of cycle policy rate hike in late May. BI responded to the recent IDR slide with a surprise 50 basis point rate hike today. The market considers the surprise move akin to the aggressiveness that the Central Bank of Turkey demonstrated early this month to successfully stabilise the country's currency.

BI's move is not surprising and reflects the aggressiveness that the bank governor demonstrated in late May when, in his first action as governor not only called for an emergency policy rate meeting just two weeks after the normal monthly BI meeting but also followed through with a 25 basis point hike.

In the past two months, BI has raised policy rates by 100 basis points, which reverses the easing from September 2016 to September 2017, in a bid to pro-actively address risks from developments in the global economic environment. There are still around 100 basis points of policy rate easing still in the system from the easing cycle of January 2016 to September 2017. We expect BI to remain vigilant and to act pre-emptively to risks. We believe that the surprise 50 basis point hike together with other BI actions will help moderate IDR's weakness and allow the financial system to adjust to the challenges of the new global economic environment.

Thailand: Current account surplus narrows in May

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Source: Shutterstock

\$958m Current account surplus in May

Lower than expected

A surprise narrowing of the current account surplus

We thought that the sharp positive swing in Thailand's customs-basis trade balance to a \$1.2 billion surplus in May from a deficit of similar size in April meant the current account was in for a wider surplus in the last month. But the balance of payments data for May revealed just the opposite; a narrower current surplus of \$958 million compared to the \$1.4 billion surplus in April. The consensus forecast was for a surplus of \$1.5 billion.

This puts the cumulative current surplus in the first five months of the year at \$19.4 billion, which is

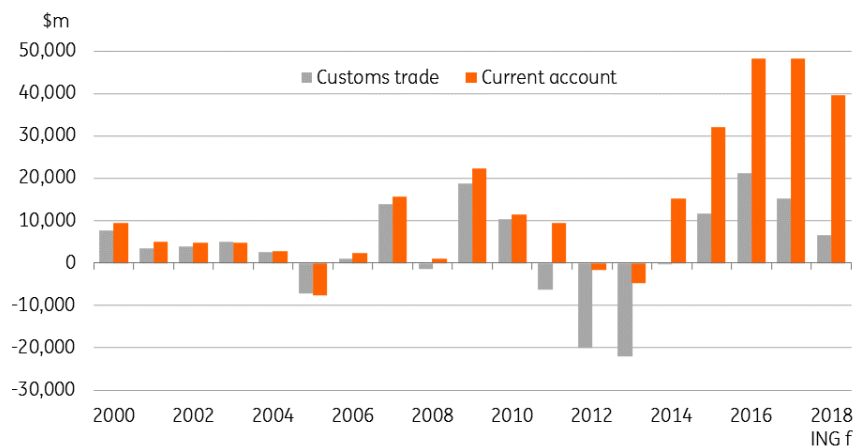
\$782 million wider on the year. The contrast with the \$3.8 billion narrowing in the trade balance over the same period reveals that services trade continued to perform well this year, thanks to the tourism sector, with a 14% year on year surge in international visitors in the first four months of 2018.

A reversal of fortune for the Thai baht

After a strong run in the last four years, Thailand's external payments have started to weaken this year and foreign exchange reserves have started to fall in May after peaking over \$215 billion in the previous two months. These trends are here to stay as the global trade war threatens exports and confidence-sensitive capital inflows while rising oil prices boost imports. We forecast that the annual current surplus in relation to GDP will narrow to 7.5% in 2018 from 10.6% in 2017.

Weakening external payments are negative for the currency. The Thai baht (THB) is Asia's worst performer in June with 3.4% depreciation against the USD, a reversal of fortune from being Asia's outperformer last year through early this year. We don't think the recent downgrade of our end-2018 USD/THB forecast to 33.8 from 32.3 will be the last (spot 33.1). We are looking for a further downgrade as we assess the impact on Asian currencies of an all-out trade war.

Narrowing external surpluses



Source: Bloomberg, ING

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