

Good MornING Asia - 22 March 2018

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By Robert Carnell



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Source: Federal Reserve

3 The total number of hikes the Fed will deliver this year ...or 4, if everything goes well

As expected

For a full analysis of yesterday's Fed decision, James Knightley's [note](#) is well worth a read. And despite the dot plot median for 2018 not changing this month, changing personnel on the FOMC suggest that a slight increase is on the cards for the next release of the dots. Moreover, so long as the data runs well, a fourth hike could well follow. One way or another, between now and the end of 2019, there are good reasons to expect the Fed funds range to nose up to 2.75%-3.00%. That's today's range (1.50-1.75%), plus two more hikes (50bp) and then plus another three (75bp) in 2019. At that point, the Fed should be done, or very nearly. Though we note that there remain a couple of hawks on the dot-plot - one looking for rates to rise to 4-4.25% and one looking for rates

to reach 4.75-5%. I don't see it myself.

Markets viewed the inaugural Powell press conference and FOMC statement as falling a little short of their hawkish expectations, and the USD was slightly weaker against the EUR and JPY. Stocks fell (not sure what they were expecting) and bond yields were down a touch, keeping the 10Y yield firmly in the 2.8-2.90 range it has inhabited for almost one month now.

The latest news from the front (war on trade)

The latest news from the war on trade is a rumoured \$50bn of tariffs against China for intellectual property violations. The sanctions will apparently be announced sometime today (US time, maybe overnight for the Asian Friday) and be imposed on hundreds of items. We haven't heard any more on a retaliatory tariff on soybeans or pork from China. Instead, China seems to be taking to the moral high-ground, with Premier Li Keqiang announcing more opening of the economy, no requirement for foreign firms to transfer technology and lower tariffs and taxes, and foreign payments firms operating under the same rules as domestic ones. China really doesn't seem to want a trade war, but we will need to see whether these latest overtures are enough to hold Trump back from a further escalation of this conflict.

Day ahead

PMI releases dominate the G-7 calendar, and these are slow moving and will show no meaningful deviation from the strong growth message delivered in recent months. No one is looking for a big shock in any direction, and barring a substantial move, these indices signal to noise ratio is weak.

The Bank of England might give GBP a lift today. Wages data yesterday were not bad at all at 2.8%YoY (last month revised higher too to 2.7%), the unemployment rate fell and employment rose - so much for businesses worrying about Brexit. A May hike, though not really warranted in our view given the absence of other inflationary evidence, looks probable, and talking it up now in today's meeting could provide the GBP some support.

Australian employment data was strong. The headline 17,500 rise in jobs in February came from a 64,900 rise in full-time jobs, more than outweighing the 47,400 decline in part-time jobs. But without wages rising, and some further signs of broader inflation, this takes us no nearer an RBA hike.

In Asia, there are plenty of central bank meetings on the calendar (Philippines, Indonesia, Taiwan). None are expected to change policy, though BSP, the Philippine Central Bank, is a more marginal call, with a small chance for a hike thought likely by forecasters.

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How will China's new central bank governor run the new central bank?

With more responsibilities to regulate the banking and insurance sectors, how will Yi Gang - the new central bank governor run the People's Bank of...



Source: Shutterstock

Yi Gang, the newly appointed governor of the People Bank of China has been part of the bank for a considerably long time and is likely to continue the ongoing reforms laid out by governor Zhou Xiaochuan which should help smooth the takeover and minimise any uncertainties on interest and exchange rate markets.

Currently, there are three policies governed by the PBoC, namely, the monetary and exchange rate policies along with capital controls and the first two are under reforms.

Interest rate liberalisation

In the recent months, the central bank increased five basis points on the PBoC 7D reverse repo (2.5%), the medium lending facility (1Y 3.25%), the standby lending facilities (1M 3.35%) when the Federal Reserve raised interest rates last year. And since 2015, the PBoC hasn't changed its benchmark deposit and lending rates which sent a strong signal that not only is it liberalising deposit and lending rates, which should invite competition among banks but also changing policy rate tools to short-term interest rates.

We believe Mr Yi is likely to continue this interest rate liberalisation, and will finally name a single short-term interest rate as the policy interest rate. In the meantime, we believe the 7D reverse repo is the key policy interest rate to watch.

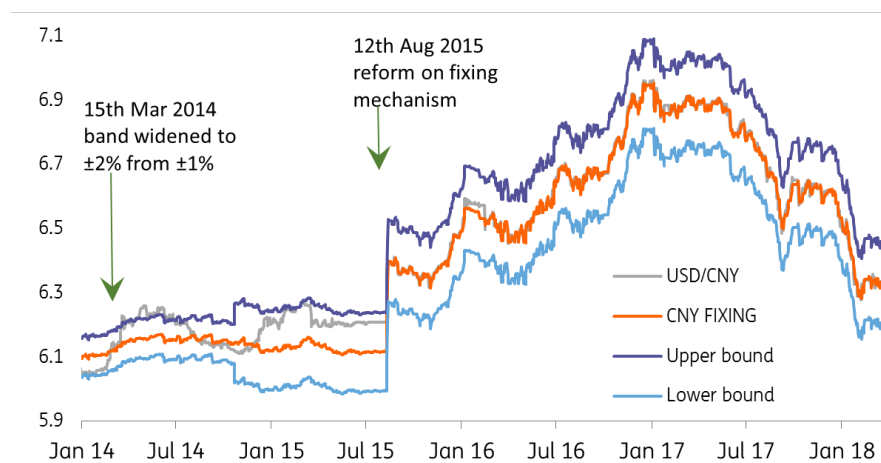
Exchange rate liberalisation

Another ongoing reform is the liberalisation of the exchange rate mechanism. The recent policy of resetting the counter-cyclical factor in the yuan fixing formula is a step towards exchange rate liberalisation, but this is still a very long road ahead for Mr Yi.

The central bank has claimed that the market is taking charge of the intraday momentum of USD/CNY, which should increase the volatility of the exchange rate. If this is true, it is still to be tested by major market movements. Since the depreciation of the yuan on 11th August 2015, the exchange rate liberalisation has moved backwards. The spot rate has stuck with the fixing, which means it does not touch the daily trading bands.

Yi Gang faces a tough job to allow the spot rate to move away from the fixing after the 11th August 2015 incident. If the spot doesn't show volatility, then there is no point to further widen the daily trading band.

USD/CNY has yet to experience genuine volatilities



Source: ING, Bloomberg

Capital controls

The PBoC, it is not independent of the government and this is crucial to understanding how the central bank tune the tightness when it implements capital controls.

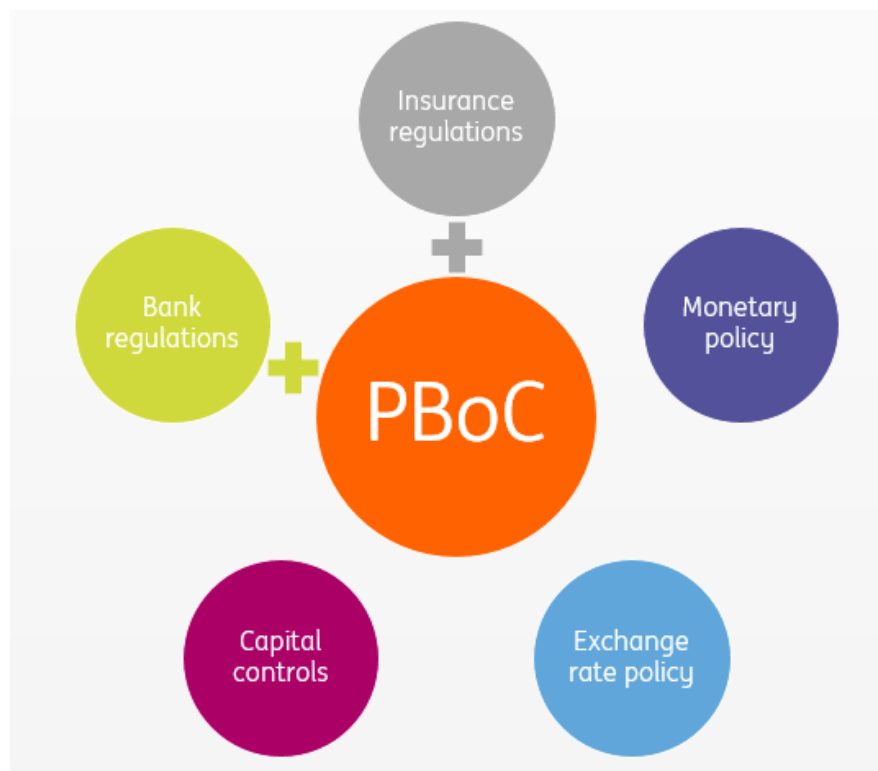
When Xi Jinping would have had a very long tenure, and Wang Qishan becomes the vice president of China, the anti-corruption campaign might become at least as fierce as in 2017. But for now, it's possible we see a fresh round of capital flight from the new political environment, which means we might see a tighter implementation of capital controls. The expected appreciation of the yuan (forecast USDCNY at 6.1 by the end of 2018) should attract inflows, which should counter-balance the outflows.

Still, it is Mr Yi's job to skillfully manage the value of capital controls so that foreign companies don't complain they couldn't make outward remittances when required and given that Mr Yi was

previously the head of SAFE, the body to control capital flows, he is well placed to do so.

Impact on financial markets now that the central bank is a financial market regulator

The central bank now has to take care of banking and insurance regulations - two new functions that will prevent Mr Yi from simply following the footsteps of Zhou Xiaochuan.



Source: ING

When financial products offered by banks and insurance companies could create credit risk, liquidity risk and market risk in the interbank it is reasonable to assume that the central bank to have better say on the regulations of banks and insurance companies.

The apparent impact is that there would be more controls on shadow banking, e.g. regulating issuance and underlying assets of wealth management products and insurance products. This would extend to capital and liquidity requirements of banks and insurance companies. We can think of a few results. 1) With decreasing number of wealth management products in the market banks may start to raise deposit rates. 2) PBoC would continue to tighten liquidity in the interbank to drive out poor credits as underlyings of wealth management products, which would directly push up short-term interest rates. 3) For banks, fewer product sales could mean lower fee income, and banks would turn to look for increase interest income to stabilise bottom line, but deposit costs are on the rise. The central bank might need to react to the dynamic changes because that could incur higher credit risks.

This is positive for the long-term growth of China's financial system as we see this as part of the financial deleveraging reform. But these functions are not only new to the central bank but also brand new to Yi Gang. We expect the central bank to be on the cautious side, i.e. to minimise the risks we mentioned when it comes to regulating banks and insurance companies. However, over-

regulating the two sectors would create slow growth and innovation in financial products and the financial market.

We stick to our forecast that the PBoC is likely to follow the Fed's footsteps to hike four times but each at five basis points to keep the interest rate spread between China and US stable. We also believe that the yuan will continue to appreciate to attract inflows counterbalancing outflows. We hold our USD/CNY forecast at 6.10 by the end of 2018.

We believe Mr Yi will continue the reforms laid out by Zhou. But the new functions mean he has new challenges, and we think he will start with caution to minimise the risks.

Welcome to China! Foreign payment companies

The central bank has decided to permit foreign payment companies to invest in China on a level playing field with local companies. Is this a reaction to...



Source: Shutterstock

Earlier today, the People's Bank of China announced foreign payment companies can now invest in China, as a signal of opening up the financial market. The timing of this policy is interesting as the US government is due to release a package of proposed punitive measures that include tariffs on imports worth at least \$30 billion tomorrow.

A crowded domestic market

It's a well-known fact that China has a competitive payment platforms market.

Not only are they well established on payment channels but also provide other services including social media, online shopping, and investment, which makes them highly competitive in terms of convenience and a range of services.

Foreign payment companies are likely to face the immediate hurdle of this fierce competition, and the high bar set by domestic payment platforms, but some will still be interested to tap the Chinese market.

An opportunity for cross border payments?

But how relevant would foreign payment platforms be for locals? Here, we think the opportunity lies in the ability to make cross-border payments. The market for outbound payment platforms isn't as crowded as the domestic payment platforms, and with increasing demand for foreign goods, Chinese consumers might find it easier to use foreign payment platforms on foreign e-commerce sites.

Given that, SAFE - the regulator that monitors cross-border fund flows, needs payment platforms to ensure that no individual brings cross-border more than US\$50,000 per year and that those funds are not for overseas investments. Put simply; the US\$50,000 is solely for cross-border consumption. Monitoring this is a technical issue but has the potential of turning into a legal issue if not done properly.

So, the risk is that foreign payment platforms are more exposed to the regulations on cross-border payments that are applied to the local ones.

The opening up of this part of the market could make the US government's claim that China doesn't treat foreign companies in the same way as domestic ones less convincing. Moreover, the area of payment platforms is a well established high-tech domestic industry, so the US claim that China "forces" foreign companies to give technology to China cannot be applied here either.

The timing of this policy is interesting. Is this killing two birds with one stone? We think that's quite likely.

Malaysia: Inflation misses estimates, again

Based on strong growth and benign inflation trends, we still look for Malaysia's central bank, Bank Negara Malaysia, to raise rates later this year



1.4%

CPI inflation in February

Year-on-year

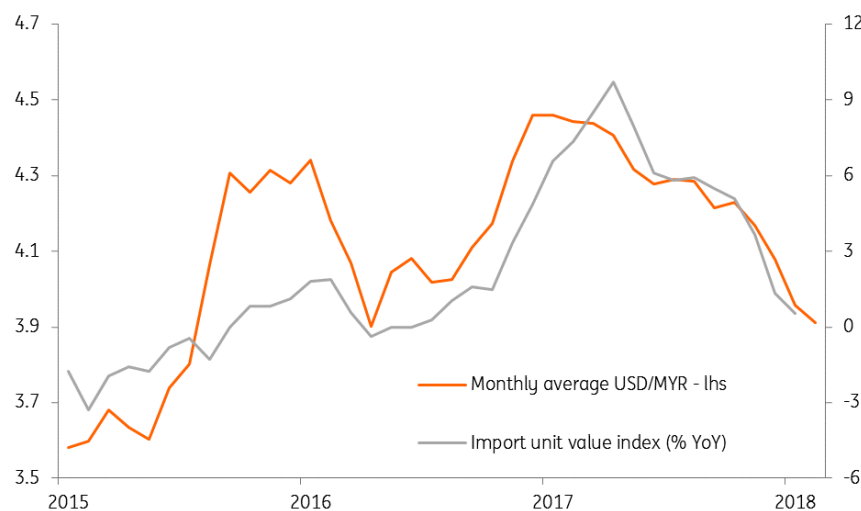
Lower than expected

Food, housing, transport drag inflation lower

Malaysia's consumer price inflation slowed more than expected to 1.4% year-on-year in February from 2.7% in January (consensus 1.9%, ING forecast 1.7%). It's no surprise that the food and transport CPI components continued to slow, thanks to the favourable base effects in both. Lower housing prices also helped despite seasonal quarterly hikes in rentals in the last month. Core inflation, which strips out food and fuel-related components from the total CPI, also slowed to 1.8% in February from 2.2% in January.

Among other inflation drivers, steadily falling inflation of import prices reflects the impact of continuing strength of the Malaysian ringgit (MYR) whereas the impact of rapid growth in domestic wages on consumer prices continues to be muted.

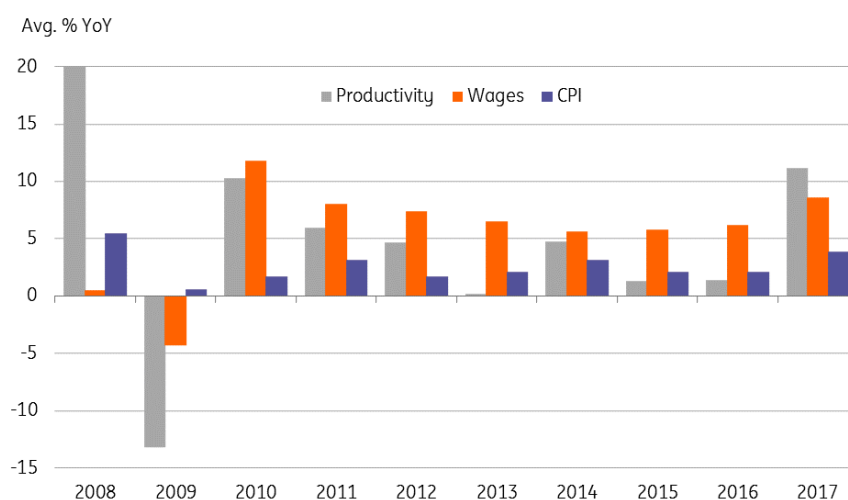
Strong currency, low imported inflation



Tight labour market has no impact on inflation

The tight labour market with wage growth outpacing productivity growth since September could be potentially inflationary. Or, it may not be. 2017 was the first year in almost a decade in which annual average wage growth slowed below productivity growth and yet inflation accelerated (see chart). History teaches us that the supply-side push to prices, especially in food and fuel sectors, is more dominant than demand-side pressures in driving Malaysia's inflation. Without any such supply shocks from food or oil prices, inflation will not be a concern throughout 2018.

Productivity, wages and inflation



Policy mix remains positive for Malaysian ringgit

Based on strong growth and benign inflation trends, we still look for Malaysia's central bank, Bank Negara Malaysia, to raise rates later this year, once the elections are out of the way. The macro policy mix of tightening monetary and loose fiscal policy is favourable for the Malaysian ringgit (MYR) to sustain its position among Asia's outperformers this year. The MYR's 3.3% year-to-date appreciation against the US Dollar is the second-best among Asian currencies. Our end-2018 USD/MYR forecast is 3.72 (spot 3.92, consensus 3.83).

Thailand: An upside trade surprise

Re-pricing for narrowing external surplus and lingering political uncertainty will likely weigh on THB performance going forward



\$808m Trade surplus in February

Better than expected

Positive swing in trade balance

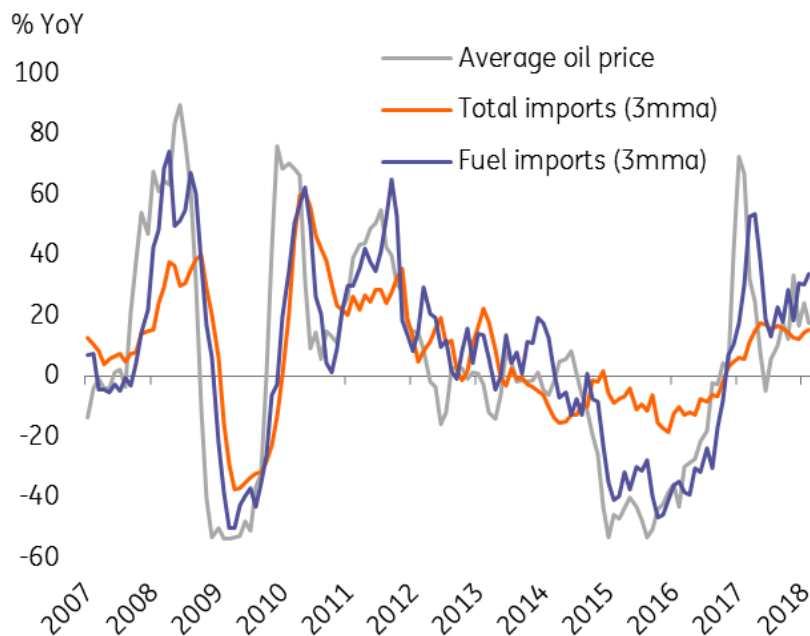
Consistent with our forecast, Thailand's external trade balance bounced to \$808m surplus in February from \$119m deficit the previous month (consensus: \$636m, ING forecast: \$831m surplus). Export growth slowed to 10.3% year-on-year from 17.6% in January while imports also slowed, to 16.0% from 24.3%.

Weak domestic spending

Import growth outpaced export growth in most of 2017 and this trend continues to hold into 2018. We view this more as a function of rising global oil prices boosting the fuel import bill (see chart), rather than an underlying recovery in domestic demand. A side effect of weak domestic demand is a wide trade surplus, albeit with a modest narrowing of the surplus underway since last year. At

\$13.9bn, the trade surplus in 2017 was \$7.3bn narrower than the previous year. It narrowed further, by \$1.7bn YoY, in the first two months of 2018. If sustained this should drive the current account surplus below 10% of GDP in 2018, from 10.8% in 2017 and a record 11.9% in 2016.

Oil drives imports



Source: Bloomberg, ING

THB re-pricing

The large trade and current account surpluses support positive sentiment toward the currency. The Thai Baht (THB) remains Asia's top-performing FX with 4.4% year-to-date appreciation against the US dollar. We believe re-pricing for narrowing external surplus and lingering political uncertainty surrounding timing of general elections will weigh on THB performance going forward. We forecast a tight range trading of USD/THB around the 31 level through the end of the year (spot 31.2, ING and consensus forecast for end-2018: 31.0).

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