

## Good MornING Asia - 26 June 2018

With trade tensions spilling over into asset markets, it is time to consider if our risk scenarios are becoming the base case

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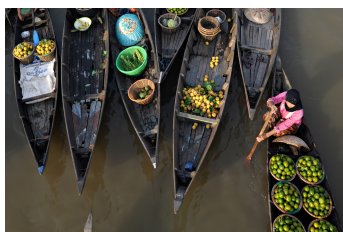
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## Risk case becoming base

With trade tensions spilling over into asset markets, it is time to consider if our risk scenarios are becoming the base case.



Source: Shutterstock

### Unintended consequences

If Donald Trump is surprised that his trade measures are leading to firms shuttering domestic plants and moving overseas, like one well-known manufacturer of classic motorcycles reported in newswires today, the rest of the world isn't. Yet I personally doubt this will cause any change of heart at the White House. Facts have become so unfashionable amongst policy setters these days. No, opinion is all that matters, boosted in many cases by generous measures of prejudice.

I could, if I wanted, take some consolation in a news story doing the rounds yesterday showing Chinese officials making last-ditch efforts to avoid the imposition of the various tariffs and retaliatory measures that both sides in this particular campaign of the global trade war have been throwing about. But I won't. Because even though it is plainly obvious that these tariffs are as bad for the US as they are for everyone else (even more obvious today), I am forming the opinion that President Trump simply wants these tariffs. He thinks he can win a trade war, and my guess is that he will continue to believe this until we have had many more casualties, like the Wisconsin based bike maker.

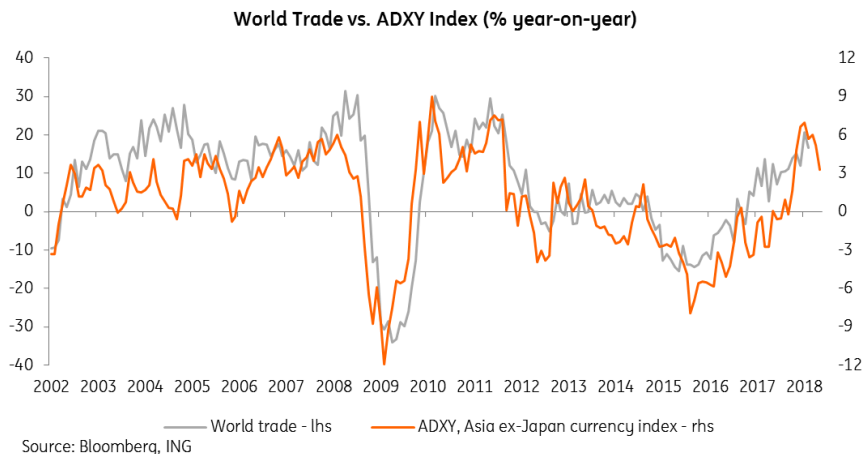
That should make us look at our forecasts quite critically. For the most part, forecasters tend to opt for a "muddle-through" scenario. It's an 'easier sell' to colleagues than a disaster. Crying 'wolf' too often will get you a bad name, and may cost you your job, though there are plenty in the market who have made a profession out of a perma-bear attitude. Being wrong, consistently, is not a

guarantee of a lot of unwanted free-time, but it helps if you have a fantastically good story to back it up. Then 'wrong' merely becomes 'early'.

Right now, an assumption of a serious interruption to global trade should make us look at a number of our assumptions:

1. Stock markets - falling sales volumes and squeezed margins, together with higher rates is not a favourable stock environment - recent declines are poised to recover from any change of heart on the trade outlook, but equally, they are poised for further declines on an intensification of this trade mess.
2. Bond yields and the yield curve - inversion is a step closer today - but not for the reasons we have been tracking (higher short rates), but because the longer end of the yield curve is now beginning to price in a chance of recession. More news like today and this will come even closer to inversion.
3. Currencies - EURUSD may be a trade-off between competing central bank views, but a negative trade scenario is unambiguously bad news for emerging market currencies. For Asian FX the correlation with global trade is tight - falling trade...weaker Asian FX (see chart).
4. If Asian FX is weaker, Asian inflation will be higher, all else being equal - that means more work for the central banks to do, and a weaker outlook for domestic growth. That isn't good for anyone.

We aren't there quite yet, but [our recent FX forecast](#) updates already took a significant step in this direction.



## Asia - Singapore in the spotlight

Today's main Asian release is Singapore's May industrial production data. Recent prints have been OK, though they have been saved by petrochemicals, and a resumption in pharmaceutical production growth after a soft patch in 2017. The numbers have been supportive of a reasonable growth projection for 2018, but not in a terribly convincing fashion, with gains typically narrowly based. Analysts look for this data to show a 10%YoY gain on a 0.2%MoM decrease in April, but it will be the composition as much as the headline figure that will be worth watching.

## G-7 - confidence is no guarantee of anything

US consumer confidence is about the only noteworthy print in the G-7 today. Consumer confidence is currently riding high - in fact, higher than pre-financial crisis highs. But as that tells you - consumer confidence is not a terribly good guarantee of continued good times. The confidence indicator was 111.94 in July 2007, steady at this level for some years. By the end of that year, it had dropped to 90.2, and it troughed 14 months later at 25.3. It is 128 currently.

A more worrying and potentially more forward-looking indicator is Germany's Ifo index, which fell further yesterday. This index has fallen now in six out of the last seven months. Trade concerns, and perhaps a little Brexit anxiety are not helping the outlook for Europe's largest economy, and by extension, the euro.

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# China RRR cut reduces risks from reform and trade war

A targeted cut in the reserve requirement ratio of 0.5 percentage point will add CNY700 billion of liquidity to facilitate debt-to-equity swaps and increase loans to SMEs. It's a policy that kills two birds with one stone, by relieving credit pressure from financial deleveraging reform and cushioning the potential impact of a trade war



Source: Shutterstock

## Creative RRR cut to reduce two biggest risks in the economy

China has cut its reserve requirement reserve ratio (RRR) by 50 basis points, releasing CNY700billion cash. But this cash will be restricted to two purposes. State-owned and large banks will use CNY500billion for "debt-to-equity swaps" while other banks, including foreign lenders, will use the remaining CNY200billion to lend to SMEs.

We think this dual purpose RRR cut will reduce the two biggest risks facing the economy by:

1. relieving corporate default pressure from financial deleveraging reform;
2. providing a cushion for SMEs that could be affected by trade wars.

## RRR cut for debt-to-equity swaps - another 'kill two birds with one stone'

The RRR cut for debt-to-equity swaps should reduce the leverage ratios of corporates that participate, and therefore the number of default cases. These are rising in China due to financial deleveraging reform that started at the end of April when several policies were announced.

This RRR cut is likely to calm the market's concerns about deteriorating credit quality of companies affected by financial deleveraging reform. Still, we do not expect an immediate fall in credit costs in the debt market. The market is likely to adopt a 'wait-and-see' approach because the debt-to-equity swaps need time to have an impact on the credit market.

### Debt-to-equity swaps in China - a primer

"Debt-to-equity swaps" in China have been developing quietly.

The current structure is that the main bank of an overleveraged company would create a subsidiary to hold the equity by reducing debt for the company (debt-to-equity swap). The subsidiary is usually in the form of a trust company or an asset management company.

The main bank would then include other investors to become equity holders of the subsidiary so that the main bank wouldn't be the only investor of the equity. Other investors could be, but are not limited to, the social security fund and state-owned asset management companies.

The swap ratio should be determined by the market, in theory. But since the number of cases of debt-to-equity swap is small, the "market price" of the swap rate is usually done by negotiations between the overleveraged company and the equity investors.

Banks need to provide extra capital for these equity holdings though they benefit from the reduction of non-performing loans or potential losses from the debt-to-equity swap.

There is a policy to restrict zombie companies (that is companies that are so highly leveraged and are targets of overcapacity cuts) to enter into a debt-to-equity swap. The purpose is to transfer risk from zombie companies to banks.

## RRR cut for SMEs will allow more loans to survive the trade war

Another element of the RRR cut targets SMEs. The purpose is the same as the April RRR cut. As the trade war escalates, we expect that there will be increasing support from the government in terms of fiscal spending like tax cuts, and monetary support of targeted RRR cuts.

Together with the April RRR cut, cash released for SME loans should increase by CNY600 billion in six months' time.

But this may not be enough to cushion an escalating trade and investment war between China and the US, as well as a global trade war that disrupts the global supply chain, in which China's SMEs would be affected. Thus we expect more RRR cuts to come in 2018.

For the same reason, we do not expect the RRR cut to have a substantial impact on the USDCNY exchange rate.

### As financing becomes more difficult default risk rising among POEs

	Total 21 papers
	From 9 distinct group creditors. 2 SOEs, 7 POEs
Defaults in 2018 (Jan to May)	Defaulted CNY11.7 billion 24% SOE, 76% POE
	Average coupon: 6.57% (ranged from 5.25% to 8%) Maturity: longest 4 years from default date
	Industry: Energy, Coal, New energy, Environmental protection, IT, Security, Energy + Finance

Source: ING, Bloomberg

## We expect the next RRR cut in October but no interest rate hike

Similar to the RRR cut in April and July (this one is effective on 5 July), we expect the next RRR cut to be in October.

We believe that the timing won't coincide with the quarter-end because the central bank would like to send a signal to the market that the RRR cut is a long-term monetary policy tool, and should not be used to ease liquidity tensions at quarter-end.

We expect the next RRR cut would be 0.5 percentage point, similar to July's cut, but not 1.0 percentage point as in April.

The 1.0 percentage point cut of RRR in April applied to some banks only, and the overall cash released was CNY400billion, which benefited SMEs. The impact is smaller than July's 0.5 percentage point cut in RRR, which is applied to all banks.

As financial deleveraging reform continues, we expect the next RRR cut to be similar to the structure of July's RRR, applying to all banks but targeting different purposes to reduce the biggest risks in the economy, specifically risks arising from financial deleveraging reform and the escalating trade war.

We no longer expect the PBoC to follow the Federal Reserve's rate hikes for the rest of 2018. Interest rates in China have been high due to rising credit risks. The central bank may not want another push higher by following the Fed.

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# Indian Banks: A fundamental overview

In India, public sector banks have been harder hit than their private counterparts. Will that trend continue? We take a look

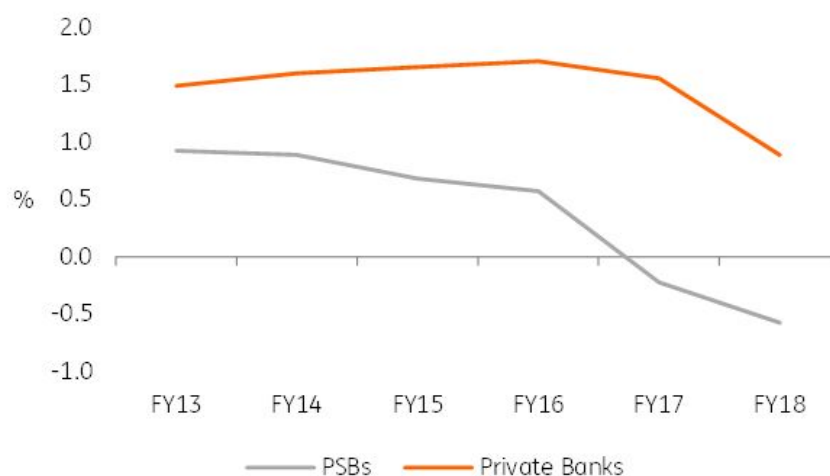


Source: Shutterstock

## Profitability

Indian banks' profitability has come under pressure over the past two years as the costs associated with cleaning up their balance sheets overwhelmed their earnings. These include not just direct costs, such as higher provisioning charges, but also the decline in income resulting from the rising load of non-performing loans. Consequently, net interest margins have been under pressure. Public Sector Banks (PSBs) have been harder hit than their private counterparts due to their higher exposure to troubled assets. We expect this to be the last year of negative profitability for them.

## Return on average assets development



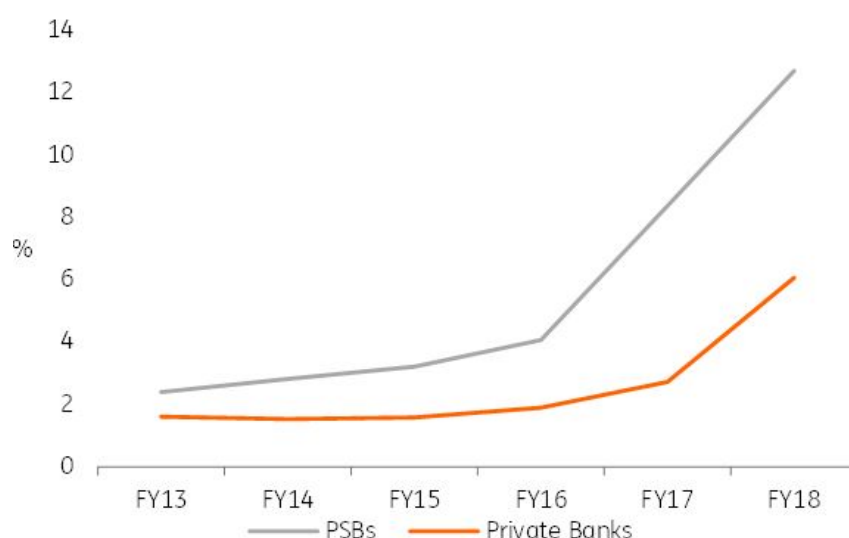
Source: Company data, SNL, ING

Interestingly, the cost/income ratio already seems to have peaked for the PSBs. On the other hand, private banks have been making a big grab for market share while the PSBs were unable to lend as freely. This has reduced their efficiency over the past year, though we expect things to settle down over the next few quarters as normal service is gradually resumed.

## Asset quality

Asset quality ratios have been declining across the sector as banks are forced to recognise and deal with bad debt. Once again, the PSBs come off markedly worse than their private counterparts, as credit costs and NPL ratios rise. The headline NPL ratio for PSBs is now very high at around 13% on average, while private banks weigh in at a more modest 6%. We expect these ratios to be close to peak levels, and they could fall swiftly as the lumpy National Company Law Tribunal exposures are worked out. Since July 2017, 41 NPL accounts (35-40% of all system NPLs) have been referred by the Internal Advisory Committee to the NCLT for insolvency proceedings.

## NPL ratio development



Source: Company data, SNL, ING

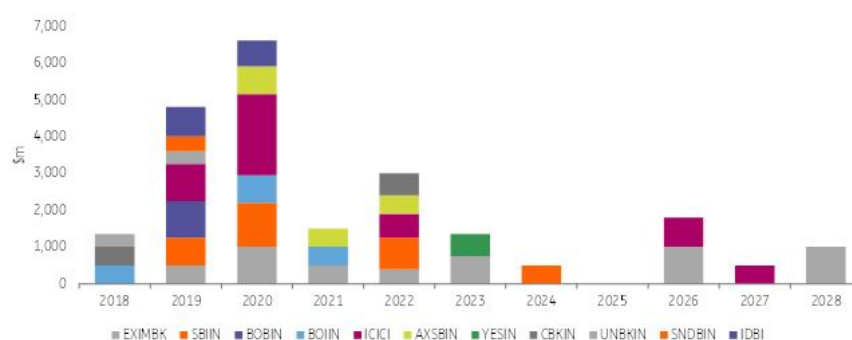
Where PSBs have outperformed their rivals, however, is in the maintenance of their provisioning cushion. Most Indian banks have a coverage ratio of about 50%. While we would like to see this ratio rise further, banks are already making such an effort on the provisioning front that it's unrealistic to expect more from them in the short term. It's interesting to note that the PSBs have managed to maintain, or even increase, their coverage ratios over the past few years, whereas their private counterparts have seen theirs slip from 80% to 50% since 2014. We think that they will arrest this decline as the market is likely to punish them if these ratios fall much below current levels, and the cyclical upswing they look set to enjoy over the next couple of years should make it easier for them to rebuild their stock of provisions.

## Liquidity and funding

Indian banks generally have a strong funding position. As is the case in China, the system has a surplus of deposits, giving the banks secure access to cheap, sticky funding pools. This can most easily be seen in the loans/deposits ratios, which stand at a very strong 75% for state banks and a reasonable 104% for private banks. The private banks have expanded their loan books aggressively over the past few years, which explains some of the rise in their loan/deposit ratios, whereas the PSBs have been in retrenchment mode.

Liquidity is also ample. Banks have considerable securities portfolios, amounting to 25% of total assets. The vast majority (if not all) of these holdings are government securities. This gives us comfort when facing Indian banks' short maturity profiles. Some 77% of outstanding bonds mature by 2022, with 57% of redemptions due in the next two years. This potential supply overhang could weigh on the market in the medium term, though investors have their minds on broader concerns at present, such as rising core rates, the strong US dollar and the possibility of a trade war between the US and China. It's worth noting that, as a relatively closed economy, Indian banks are better protected against these risks than many similarly rated peers.

## Indian bank maturities (USD senior paper)



Source: Bloomberg, ING

## Capitalisation

Capital ratios vary widely across the sector and are PSBs' Achilles' heel. Two years' losses (in some cases) have caused capital depletion, such that the average Tier 1 ratio is 10%, which is adequate but not comfortable. Having said that, the sector should be able to generate organic capital again once it returns to profitability in the next few quarters, while the INR 2.1 trillion capital injection into PSBs will neutralise the expected losses from NPL write-offs. Private banks are faring much better. Despite significant RWA inflation over the past year, Tier 1 ratios are at 14% on average, which is very strong. The contrast is even more stark when we look at a truer picture of banks' leverage, the Tangible Equity/ Tangible Assets ratio, where the average for the private banks is 9% against a mere 6% for the PSBs.

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## Indian Banks: The final cleanup

Indian banks are going through the final phase of their balance-sheet cleanup. This completes a five-year process of purging legacy non-performing loans from the sector, and should see large public-sector banks return to profitability over the next 12 to 18 months



Source: Shutterstock

While we are positive on the sector's fundamental momentum, we observe that spreads are relatively tight. We also expect significant issuance over the next two years as 57% of hard-currency Indian bank bonds will mature by 2020.

- Indian bank regulations have come on apace and government support for the sector is not in question. The country now has a working time-limited insolvency regime and a regulator with the power to force banks to work out stressed assets.
- To cope with the costs of the legacy cleanup operation, the Indian government is recapitalising public-sector banks to the tune of INR 2.1 trillion, at the high end of expectations.
- Public-sector banks have much weaker balance sheets than their private counterparts due

to their higher exposure to stressed sectors. They also dominate the sector, accounting for over 70% of banking assets. This explains why the government's remedial measures are aimed more at them than at the private sector, which is less in need of assistance.

- We therefore expect private sector banks to continue to gain market share and outperform their public peers for the next year.
- We note that the Indian bank bond market is of exceptionally short duration, with 77% of hard-currency senior bonds maturing in the next four years. This has resulted in squeezed valuations in the short end.
- We may therefore advocate looking further along the Indian bank curve for value and sticking to established private banks, as there is no significant discount in bond pricing for accidents, despite the execution risk inherent in bailing out large troubled lenders (eg, IDBI's NPL ratio stands at 28%).

## Structure of the market

The Indian financial system is growing and well-balanced. While the overall system is stable at 136% of GDP, little changed over the past seven years, it has doubled in nominal terms over that period and is rapidly becoming more diverse. The market shares of non-bank intermediaries, such as mutual funds, and private banks are growing from a low base, while banks' share of credit flows dropped significantly from 50% in FY 2016 to 38% in FY 2017, as corporates increasingly replace bank funding with private sources. The size of the system and its growing diversification are both healthy, as is its limited cross-border interconnectedness; cross-border lending and borrowing stand at just 10% and 14% of GDP respectively, insulating Indian banks somewhat from external financial shocks.

Banks dominate the Indian financial system, accounting for 60% of system assets. One key aspect of the Indian system is the high level of interconnectedness between the government and the banks. Some 70% of system assets are held by the Public Sector Banks (PSBs), which are majority owned by the State. Moreover, all banks must hold at least 20% of their assets in government securities. Banks must also allocate 40% of net credit to [Priority Sector Lending](#). Priority sectors include Agriculture (at least 18% of loans), Micro Small & Medium Enterprises (MSMEs – at least 7.5% of loans must go to the Micro segment), export credit, education, housing, social infrastructure and renewable energy. While all banking activities are carried out commercially, the government clearly does direct the flow of loans to its priority areas, somewhat distorting the market. However, the government remains very supportive of the banks, with a long history of providing capital support when necessary, the latest instance of which is the final instalment of the balance-sheet clean-up operation that began in 2016 and should be completed next year.

## The big issue – legacy NPLs and new regulation

From the top-down, India's financial system therefore seems fairly balanced. It also benefits from a very stable base of excess customer deposits, making funding comfortable. The big challenge for the sector over the past few years has been a high stock of non-performing and restructured loans. This problem is finally being tackled head-on after several years' regulatory build-up, making us

confident that the banks will finally clean up their balance sheets over the next 18 months.

Problems arose following the build-up of high corporate leverage to support infrastructure investments in the 2000s, which was largely financed by the PSBs. Deteriorating global conditions, weak domestic demand and structural bottlenecks (e.g. delays in environmental clearances) from FY 2014 hit banks hard, particularly in their Metals, Engineering, Transportations and Infrastructure loan books, leading to a significant deterioration in asset quality.

A further imbalance was created through widespread use of the 5:25 scheme to fund long-term infrastructure assets, whereby a lack of long-term funding meant that loans were granted as bullet structures for five years at a time on the understanding that they would be rolled for 25 years. When asset quality in these crucial sectors deteriorated, the authorities' first response was to create various restructuring schemes to obviate banks' need to recognise these bad assets; these included the Strategic Debt Restructuring (SDR), Flexible Structuring of Project Loans (5:25) and the Scheme for Sustainable Structuring of Stressed Assets (S4A). Multiple restructurings and/or evergreen finance were possible.

However, as banks' financial positions continued to deteriorate, curtailing credit growth, reducing government dividends and necessitating a drip-feed of capital infusions, regulators decided from 2014 to tackle the problems head-on. This resulted in a raft of regulatory measures transforming the banking landscape. The main planks of the plan were as follows:

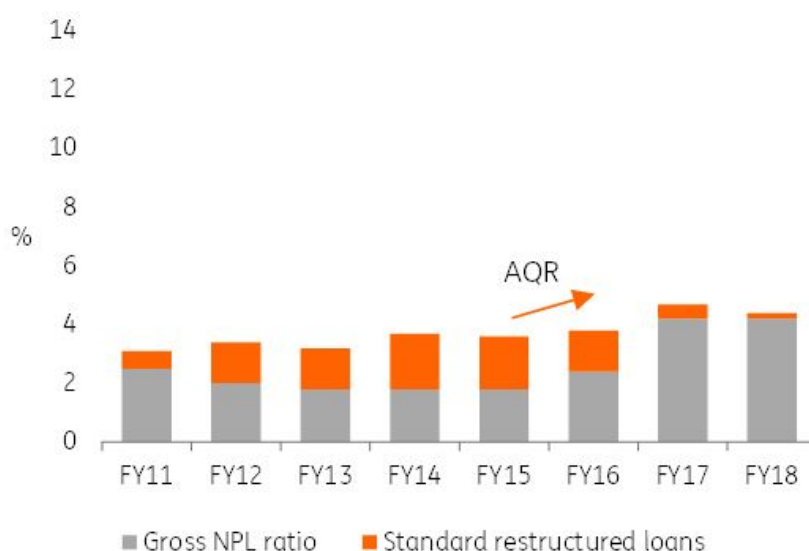
- In February 2014, the RBI set up the Central Repository of Information on Large Credits (CRILC), capturing all exposures of banks above Rs 50 million. The data was accessible to the RBI and to banks themselves, adding transparency to the system to enable all to see how large exposures were marked on various books.
- In 2015, the Indradhanush Plan introduced critical governance innovations in the PSBs, such as the creation of the Banks Board Bureau to improve the quality of Board candidate, splitting the roles of Chairman and Chief Executive and attracting qualified private-sector candidates for top positions.
- At the same time, the RBI carried out an Asset Quality Review on the banks, prompting a spike in NPLs as more bad assets were recognised. PSBs fared markedly worse than the better-run private banks on this score.

## PSBs' NPL ratio development



Source: Company data, Moody's, ING

## Private banks' NPL ratio development



Source: Company data, Moody's, ING

- Finally, in 2015, general forbearance, known as “standard forbearance” was forbidden. The only forbearance now allowed were the schemes listed above: SDR, 5:25 and S4A.
- In 2016, the Insolvency & Bankruptcy Code (IBC) was enacted. It envisages timely resolution of borrower defaults through collective decision-making by creditors. The code not only provides a process to deal with insolvency but also lays down strict timelines for insolvency resolution, failing which the borrower will be liquidated.
- The IBC obviated the need for forbearance mechanisms, as troubled loans could now be resolved. Consequently, the Banking Regulation Act was amended to authorise the RBI to

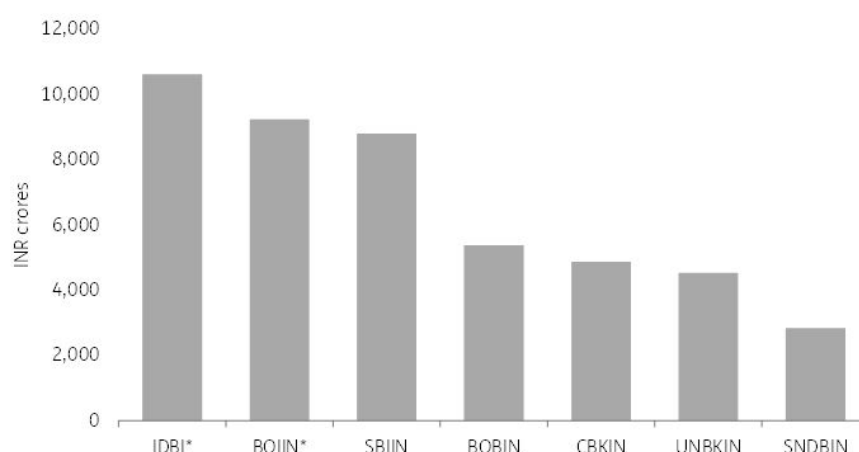
direct banks to refer specific cases to the IBC where necessary. The RBI formed the Internal Advisory Committee (IAC) to carry out this task.

- Since July 2017, 41 NPL accounts (35-40% of all system NPLs) have been referred by the IAC to the National Company Law Tribunal (NCLT) for insolvency proceedings under the IBS. If these accounts cannot be resolved within 270 days, they will be liquidated. The process consists of two tranches: NCLT1 started in July 2017 and covers the 12 largest NPLs, accounting for around 25% of system NPLs. NCLT2 started in December 2017 and covers the next 29 largest NPLs (10-15% of system NPLs). Most banks have 60% coverage against NCLT1 accounts, which include three steel companies (Bhushan Steel, Electrosteel Steels and Monnet Ispat & Energy), one auto company (Amtek Auto) and one engineering firm (Jyoti Structures).

While these measures proved effective at accelerating NPL work-out rates and recognising troubled assets, they proved expensive for the banks, where heightened provisioning costs and lower interest income hit profitability and regulatory capitalisation. Over the past nine months, the authorities finally bit the bullet:

- In October 2017, the government announced an INR 2,11,000 crore (\$32 billion) recapitalisation of the banking sector, at the higher end of expectations. The money will come in three tranches and will be front-loaded: INR 1,35,000 crore from recapitalisation bonds, INR 18,139 crore from budgetary provisions and the balance of INR 58,000 crore from capital raising by banks from the market while diluting government equity (which should go some way towards solving the problem of high levels of government investment crowding out the private sector). The chart below shows how much capital each bank has been allocated:

## Selected banks' capital infusions



Source: Ministry of Finance, ING

\*Banks in PCA

- In February 2018, the RBI launched its revised [framework for the resolution of stressed](#)



**assets.** Key provisions include the need to report loans that are overdue even by just one day, the need to update the CRILC monthly, the abolition of the remaining forbearance categories and the codification of the 180-day limit for the work-out of bad loans.

- Finally, in April 2018, the RBI revised its Prompt Corrective Action (PCA) framework for banks in line with international best practices. Banks will now be categorised in one of three risk levels depending on capitalisation, profitability and leverage, with mandatory remedial actions becoming more stringent if banks' financial positions weaken. All details are available [here](#).

India has therefore moved from an environment where the lack of an insolvency regime led to mass forbearance of bad debt to one where an effective bankruptcy code now exists, is enforced, is timely and where capital injections have been provided to ease the balance-sheet cleanup operation. Bank oversight and governance have been improved and a transparent early-warning system has been created. Progress has been really impressive.

## So where does this leave banks?

### **NPL ratios are set to rise...**

PSBs are in a weaker position than their private counterparts, mainly because they have been exposed to struggling lumpy infrastructure debt. Reported NPL ratios for PSBs stand at about 12.9%, whereas they are “merely” at 4.7% in the private sector. On top of that, banks still hold significant restructured loans, which will be recognised in the near future. The RBI has given banks until August 2018 to resolve their restructured loans or classify them as non-performing and act accordingly. These comprise 1.8% of “standard restructured” loans (i.e. legacy loans from previous forbearance schemes), most of which will become NPLs; and another 1.8% of loans restructured under now-defunct schemes, the bulk of which will also become NPLs (with the exception of some performing 5:25 exposures). Private banks have a similar issue, though on a smaller scale: reported NPLs stand at around 4.7% of total loans, with a further 1.1% of loans restructured under the abolished schemes and 0.6% of internally classified stressed loans.

### **...While higher provisions will dent profitability**

We expect provisions to rise as assets migrate from the stressed to the non-performing buckets. The change of rules regarding restructured loans required provisions of 40%, up from the current 5%. Profitability will be further impacted by the discovery in February of INR 126bn of fraudulent transactions at Punjab National Bank (c.0.25% of system loans), which are likely to be written off. We also note that the rise in yields is causing substantial mark-to-market losses on banks' securities holdings, although the RBI has given them one-time leeway to spread these losses over four quarters. Overall, we see little chance of current credit costs of 2.5-3.0% subsiding in this financial year, and weaker banks are likely to post further net losses.

However, fresh capital and a friendly regulator should help the system get through this period of restructuring to emerge much stronger on the other side. Once again, private banks are likely to outperform the PSBs.

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## Indonesia: May trade deficit is the second worst in four years

The deficit of  $-\$1.52\text{bn}$  is the second worst in four years and is expected to further deteriorate to  $-2.5\%$  of GDP in the second quarter. We expect all of this to keep the rupiah on the defensive but another hike this Thursday should provide some relief



Source: Shutterstock

# $-\$1.5\text{bn}$

Worse than expected

## May trade balance

Second worst since April 2014

Indonesia's strong import growth in the past two months has resulted in its two largest trade deficits since April 2014.

May imports remained strong posting an annual increase of 28.2% year on year, higher than market expectations but slower than April's pace of 35.2%. Exports improved in May posting a 12.5% growth in May after April's 9.6% increase from a year ago.

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*We now expect the second quarter current account deficit to be around -\$6.5bn or -2.46% of GDP, worse than the first quarter deficit of -\$5.5bn or -2.15% of GDP*

---

However, exports remain relatively weak when compared to the strong growth of 25% in May and 14% in April. Strong oil imports resulted in a large net oil deficit that mainly accounted for the worsening of the trade balance. Net oil balance was a larger deficit of -\$1.2bn in May, worse than April's deficit of -\$1.1bn. Despite the export improvement, May trade deficit amounted to -\$1.5bn from April deficit of -\$1.6. The April-May trade balance worsened to a total deficit of -\$3.2bn, from a year-ago surplus of \$1.9bn.

This reversal does not bode well for the second quarter current account.

We now expect the second quarter current account deficit to be around -\$6.5bn or -2.46% of GDP, worse than the first quarter deficit of -\$5.5bn or -2.15% of GDP.

The weak trade and current account position would likely keep IDR on the defensive. Relief from recent IDR weakness would likely come from another policy rate hike at this Thursday's Bank Indonesia policy rate meeting.

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# Singapore May inflation noses a little higher

All items consumer price inflation is still only 0.4%YoY (May), but the MAS core inflation rate has also edged up and now stands at 1.5%YoY.



Source: Shutterstock

## Rising inflation signals that the economy continues to make moderate progress

The 0.4% inflation rate for Singapore remains very low by historical standards, but the Monetary Authority of Singapore (MAS) tends to focus on its 'core' measure. This, unlike most core measures that exclude food and energy, excludes housing and private road transport. With public provision of housing and its associated rents a key channel of government policy, and the certificate of entitlement (COE - a compulsory license) for driving a car in Singapore another, the MAS' core measure comes up with an inflation rate of 1.5% - not a million miles away from the upper half of a 1-2% range that it outlined in its April Monetary Policy statement.

## What's driving inflation? History...

Housing delivered a big inflation swing on the month (-2.6% rising to +2.5%YoY), though this is basically just the unwinding of the quarterly public housing rebate and can be ignored. Imputed rentals on owner-occupied housing continue to rise, however, suggesting that the private accommodation market remains in slow recovery mode.

The other excluded element of the MAS core measure, private road transport is partly a function of the COE. But since May, when on average it was a little higher than April, the COE has trended down. This may provide a bigger drag in June than it was for this latest release, keeping the headline rate from moving abruptly higher even if it has no bearing on the core rate. Transport inflation as a whole rose 0.7pp from April, though the monthly increase was unchanged at 0.2%. There is nothing really going on here apart from some volatile history.

Moreover, although they are excluded from the core measure of inflation for being too heavily influenced by government policy to be meaningful, excluding the items above does suggest a strength in the underlying state of the economy that we are not convinced exists. For example, COE prices may be excluded from the MAS core price, but they are still a legitimate indicator of baseline domestic demand, and they are currently consistently falling across all price brackets for cars.

Other subcomponents showing weakness include food, which dipped 0.1%pp to 1.3%YoY, and clothing and footwear (0.6%YoY down from 0.8%). Most other goods, including (unhelpfully) miscellaneous goods, saw inflation rise. In the case of the miscellaneous component, inflation rose to 1.1% from 0.5%, though this seems to be almost entirely down to alcohol and tobacco (+5.7%YoY) even if these prices did dip 0.3%MoM, and this should be less of a boost in June.

## October MAS meeting probably leaves policy unchanged

Putting this all together, the story of economic improvement in Singapore remains intact, though hardly looks invulnerable. As we near the October MAS monetary policy decision, as things stand, it is hard to see there being another tightening. And the most likely outcome, especially taking into account the increasingly uncertain external backdrop, is for policy to remain on hold.

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## Taiwan's electronic sector holds up well but keep an eye on market volatility

The export-driven economy seemed to be doing fine in May as electronics supported industrial production growth. As trade tensions escalate, we forecast USD/TWD to reach 30.60 by the end of 2018



Source: Shutterstock

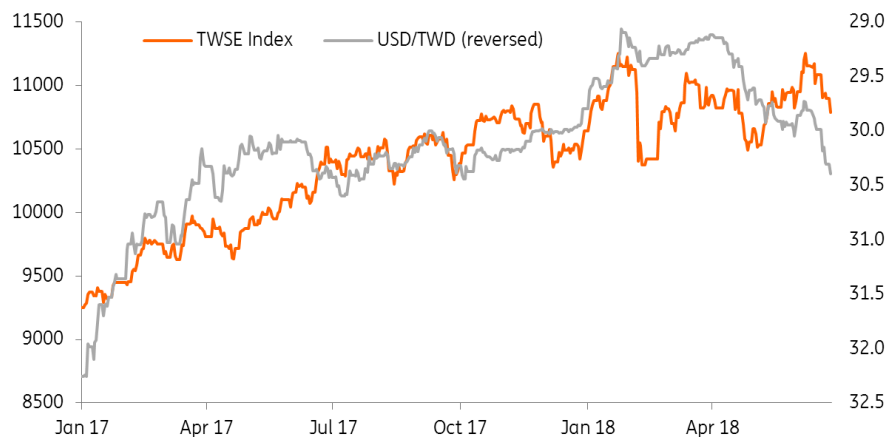
Industrial production grew 7.05% year on year, of which integrated circuit production grew 17.56%YoY and electronic parts production grew at 9.38% YoY. Other computer parts grew by 19.74%, mainly brought by the production of cameras used in new handset models.

### But this is data from May - trade tensions have escalated since

It is true that data in May shows Taiwan's manufacturing industry, and therefore the economy was running well. But trade tension between Mainland China and the US have escalated since.

We believe if a trade war materialises between Mainland China and the US, then world trade volume would shrink, and that would put Taiwan's export-driven manufacturing industry at risk.

## USD/TWD would continue to rise in the middle of escalating trade war



Source: ING, Bloomberg

We forecast USD/TWD to reach 30.20 by the end of 1H18 and 30.60 by the end of 2018.

Today's bearish sentiment, arising from the news that the US could ban Chinese companies' investments in the US for security reasons, has fueled depreciation of the yuan as well as the new Taiwan dollar.

The market is very sensitive to news relating to a trade war, and market participants should watch out for increasing volatilities in asset markets.

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