

Good MornING Asia - 28 February 2018

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In this bundle



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China

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Opinion | 27 February 2018

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Source: Shutterstock

Powell- it's the little things...

I have to admit that my prior expectation was that Powell's speech would be as dull as most such speeches are. But markets certainly found it interesting enough. US bond yields rose, more at the back end than at the front. Nonetheless, markets have taken on board Powell's generally upbeat view on the US economy, and have moved expectations to fully price in three hikes this year (we think 4, and this would be more in line with Powell's remarks) and a further 2 hikes in 2019 (we are again more aggressive - looking for Fed funds to end 2019 at 3.0%, not the 2.5% implied by market pricing).

Of the other things we note from Powell's speech, one is an explicit recognition that fiscal policy is now providing a firm push to the economy. As such, this will allow the Fed to lean gently back against it in the opposite direction. The other point was a fairly blunt remark about the merits of policy rules for monetary setting. This was part of the debate prior to Powell's appointment. Indeed, John Taylor - he of the eponymous "Taylor rule", was a front-runner for Powell's job at one stage. So do we need to start dusting off some of these rules? With economic and monetary conditions beginning to normalise, that might not be such a bad idea.

Dollar following rates again - is this a trend?

One other observation about last night's speech by the new Fed chair is that the USD seems to be following yields again. Stocks sold off as bond yields rose, but the dollar firmed against the EUR. Asian FX also seems to be starting the day on the back foot, with the exception of the KRW. This despite yesterday's BoK speech, where the outgoing Governor noted that the BoK would not follow the Fed hike-for-hike (did anyone really think that likely?). Strong Korean business surveys out early this morning may be helping the KRW.

The region's deficit currencies, (PHP, INR, IDR) look to be amongst the weakest today, though the SGD has also lost a fair bit of ground against the USD, after gaining on production data in recent days and increased thoughts of an April MAS tightening.

Day ahead...

Japan has already kicked off the G-7 calendar for today with retail sales figures, which were poor, as were their industrial production figures for January. Alarmingly, electronics production, the mainstay of many Asian economies 2017 economic strength, were one of the main reasons for weakness of both production and shipments. The potential for a turn in the electronics / communications product-cycle bears very close watching in coming data across the region. Besides that, it is a relatively uneventful day, with February Eurozone CPI probably the main G-7 pick, and likely to dip to 1.2%YoY from 1.3% in January following a downside miss by Germany yesterday. This doesn't help the ECB to smoothly exit its current QE programme, and this too could be weighing on the EUR currently.

In non-Japan Asia, Hong Kong will be announcing what they will do with their massive fiscal surplus. China PMIs will be largely ignored given the influence of the New Year on the figures, Thai trade data is not hugely informative, given their huge trade surplus (the THB is strong, but none of this helps a beleaguered domestic economy). Indian 4Q17 GDP data should paint a better picture following the ravages of demonetisation and GST on activity earlier in the year. Consensus expects a 7.0% YoY growth rate for the fourth quarter.

Author

Olivia Grace

Editor

olivia.grace@ing.com

Julian Geib

Junior Economist, Global Trade

julian.geib@ing.de

Zoltán Homolya

Economic research trainee

zoltan.homolya@ing.com

Amrita Naik Nimbalkar

Junior Economist, Global Macro

amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz

Senior Economist, Poland

mateusz.sutowicz@ing.pl

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@ing.com

Michiel Tukker

Senior UK & Eurozone Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Senior Economist, Healthcare & Technology

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Antoine Bouvet

Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

Hong Kong: Is proximity to China still an advantage?

Hong Kong has benefited from its geographical proximity to Mainland China for a long time, but that's no longer the case for all sectors. Asset-related sectors continue to leverage this advantage a lot better than tourism and the re-export sectors



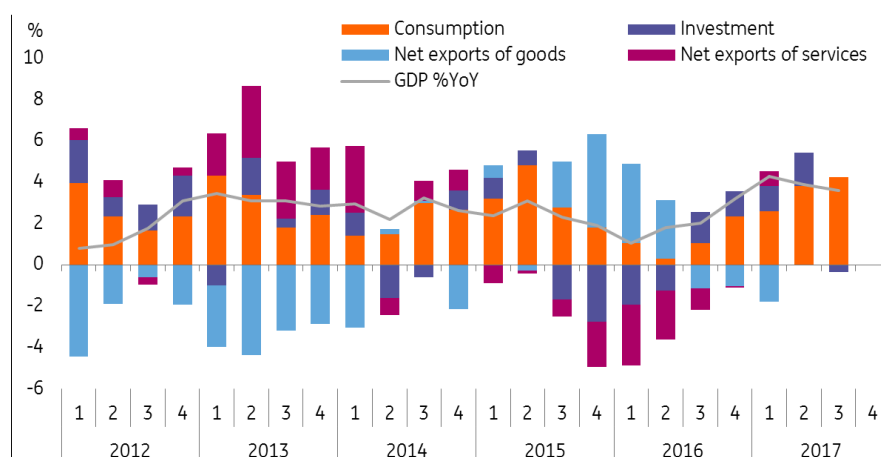
Source: Shutterstock

Fourth quarter growth should improve, but expect it to come down in 2018

Fourth quarter GDP figures will be released tomorrow (28th March), and we are still looking for growth of the Hong Kong economy albeit slightly slower from the 3.6% year-on-year in the third quarter and the overall 3.8% in 2017.

Better growth could come from consumption and investment in private and public construction. However, we believe growth will continue to slow to 3.5% in 2018 and also in the future due to changes in the economic and financial relationship with Mainland China.

Economic structure in Hong Kong is changing



Source: ING, Bloomberg

Re-export and tourism sectors no longer benefiting from proximity to China

Hong Kong's GDP components show us that so far, consumption has been the key contributor in 2017. This is very different from the past when net exports of goods played an important role, just as much as consumption. When net exports of goods began to decline in 2016, the economy placed its hope on the net export of services, which was largely tourism.

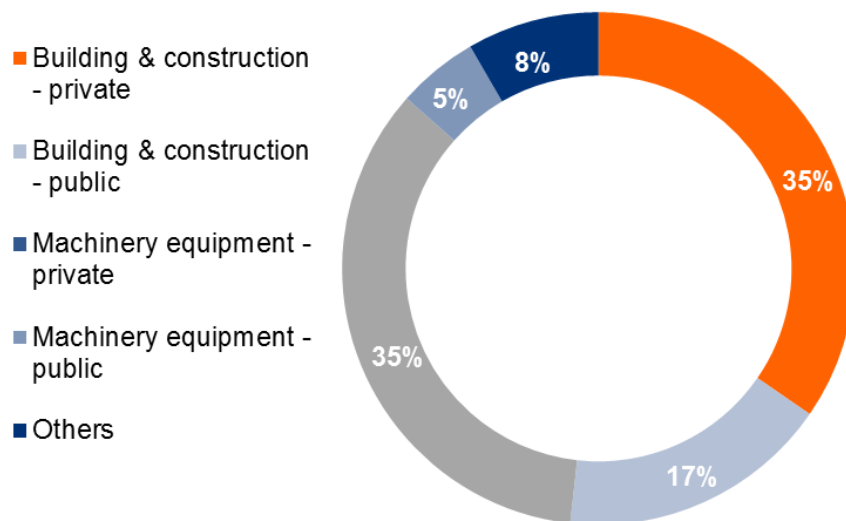
But 3Q17 told a mere consumption story for Hong Kong, which makes us question if Hong Kong is still leveraging its geographical proximity advantage with Mainland China.

In the past, Hong Kong offered port services to Mainland as Hong Kong is a free port, and located right next to it. But, as the Mainland has developed its own port with better facilities, this means Hong Kong is losing its advantage as a re-export centre for Mainland China.

Tourism is another sector Hong Kong has been pinning its hopes to - as in the past it has been responsible for pushing up retail shop rentals among the world's highest. This has also changed as Mainland tourists prefer long haul travel for their long holidays, and Hong Kong has become a short break location.

The retail sector has felt the change with short-haul tourists usually spending less, and that reflects in the small contribution of net export of services in Hong Kong GDP.

Investment has been moved by private constructions



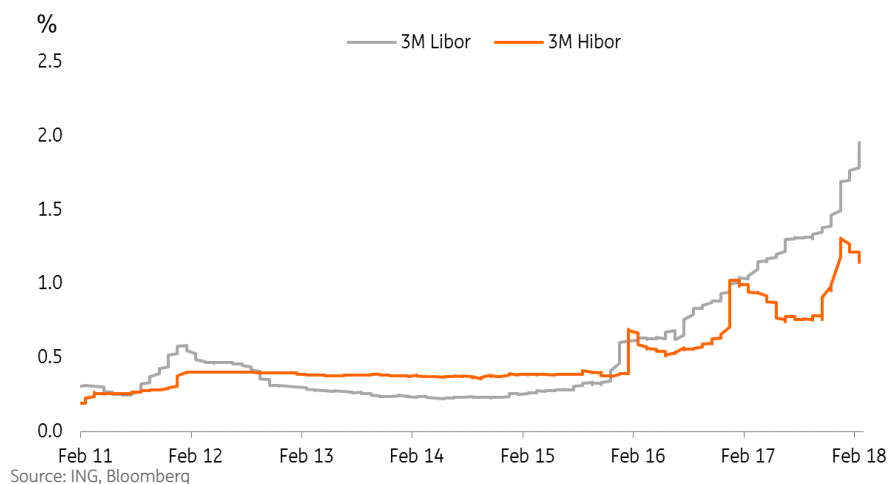
Source: ING, Bloomberg

Property and financial sectors benefit from China money

The way that Hong Kong taps China's opportunities become increasingly involved in China's "going-out" money. For example, Chinese corporates' offshore headquarters are likely to be located in Hong Kong, which has pushed up office prices in the past two years.

Sure, Mainland investors are also interested in Hong Kong's residential properties, which has led to an average of 14% increase in home price in 2017. Moreover, the Hang Seng Index increased 35.99% in 2017, and all of these have led to higher asset prices in Hong Kong in 2017.

Hibor has been reluctant to follow Libor even under the HKD linked exchange rate system



Source: ING, Bloomberg

The case of ample liquidity in Hong Kong

Part of the reason that Hong Kong's short-term interest rates (Hibor) have not followed Libor is that Hong Kong has too much liquidity. It's not difficult to understand that the money comes from Mainland China as cross-border businesses between the two have continued to increase.

We continue to believe that the abundant liquidity position will not change in 2018, and therefore Hibor would only follow Libor temporarily when the Fed raises interest rates. We are likely to see Hibor fall between each Fed's rate hike.

And before USD/HKD touches the upper bound of 7.85, HKD will continue to be weak as the HKMA would buy HKD when it touches 7.85.

What could change in 2018?

Our baseline scenario remains that the current ample liquidity in Hong Kong will continue in 2018.

The risk of tighter liquidity in Hong Kong could come from increasing regulations about money leaving China, but the risk is not high. As the yuan continues to strengthen, there will be more money inflow into China; this will give room for capital outflows as Chinese regulators need not worry about the risk of capital flee.

Author

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

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