

Good MornING Asia - 3 December 2018

After a constant battering by China-US trade tensions for most of this year, the weekend developments come as a significant relief for the markets. How long the trade truce will last remains a question though

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Escalation of the trade dispute is the key risk to China in 2019

2019 will be a difficult year for China in terms of economic growth and the increasingly tricky political relationships with its trading partners.

An escalation in trade tensions is the key risk to China in 2019 – and this seems like the most probable scenario. This will hurt exporters, manufacturing and logistics services, therefore slowing economic growth directly.

Indirectly, the bilateral trade conflict between China and the US has resulted in multilateral trade and investment disputes. This is exacerbated by international voices blaming the Belt and Road Initiative as a debt pile-up exercise for poorer economies. It has become more difficult to maintain existing relationships with trade and investment partners. The recent APEC meeting showed these economies having difficulties positioning themselves between China and the US.

Sizeable fiscal stimulus and looser monetary policy will see only a moderate slowdown next year

Having said that, we are not too worried about the economic growth rate. We expect GDP growth to slow to 6.3% in 2019 from 6.6% in 2018.

This moderate slowdown in growth reflects our projection of fiscal stimulus worth between CNY 9-10 trillion from late 2018 to 2020, averaging about CNY 4 trillion each year. The size of this stimulus is comparable with that of 2009-2011's CNY 4 trillion, taking into account that nominal GDP has grown by 2.3 times between 2009 and 2018 to CNY88.6 trillion (rolling four quarters to 3Q18).

Manufacturing PMI approaching 50 and below



Source: Bloomberg, ING

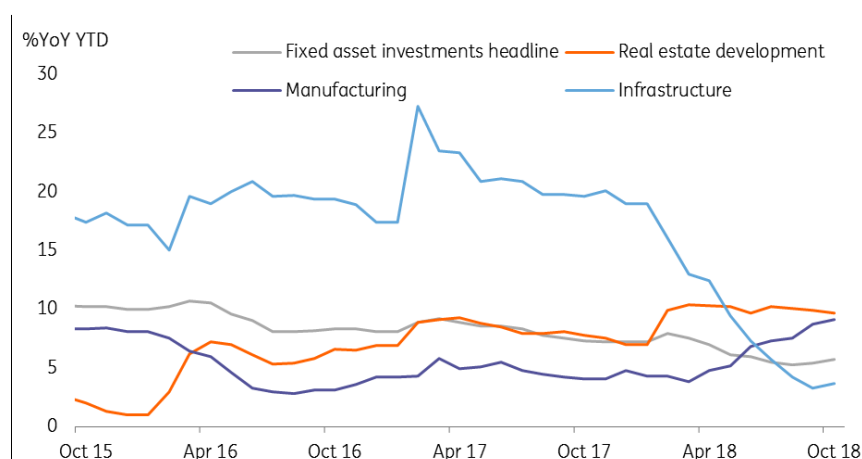
GDP won't rise proportionally to the fiscal money spent

This fiscal boost will take the form of tax cuts (salary tax cuts and more export tax rebates), creation of capital pools for advanced technology R&D, the creation of liquidity pools for small private companies, and infrastructure projects. We'd emphasise that fiscal spending on infrastructure projects may not reflect the same scale of increase in fixed-asset investments. This is because some of the money will be used for repayment of debt from local government financial vehicles (LGFVs) that finance infrastructure investments. Put simply, fiscal money spent will not result in a proportional increase in GDP. This also reflects the fact that the debt problem in China has yet to be solved.

Moderately loose monetary policy to support small private firms

We expect monetary policy to provide support to the economy, mainly to small private firms. Liquidity injections via cuts in the reserve requirement ratio (RRR) are necessary to keep private firms running. Again, some of this money will be used for debt repayments. To lower the interest burden when risk premiums should be rising, we expect the central bank (PBoC) to also cut its seven-day reverse repo policy rate twice (in [1Q19](#) and [3Q19](#)).

Infrastructure investments have increased in Oct18



Source: Bloomberg, ING

Housing market restrictions will be relaxed to support growth

Restrictions on the housing market could be relaxed, as the government won't want another drag on the economy during the ongoing trade dispute, and the housing market could support construction activity.

USD/CNH crossing the 7.0 handle is a high probability scenario

We forecast the USD/CNY and USD/CNH will reach 7.30 by the end of 2019 from 7.00 by the end of 2018, as the trade conflict escalates.

Unlikely scenario: Resolution to trade conflict, what would happen?

In the unlikely event that China and the US agree to withdraw tariffs altogether, the Chinese government would focus again on reducing the economy's debt pile. This could prove just as difficult as facing a trade war. The deleveraging reform has been shelved since the middle of 2018 because the government has had to focus on combating the trade dispute. Within these few months, debt has piled up quickly within local governments, and LGFVs have made a comeback. It would take another few years (just like 2016 to mid- 2018) to reduce debts of LGFVs, not to mention state-owned and privately-owned enterprises that receive liquidity for survival. In this scenario, GDP growth would be around 6.5%, depending on how fast the government wants to clean up debts. If the trade conflict were to end, the yuan would likely appreciate against the dollar to 6.50 by the end of 2019.

China: PMI disappoints but stimulus is coming

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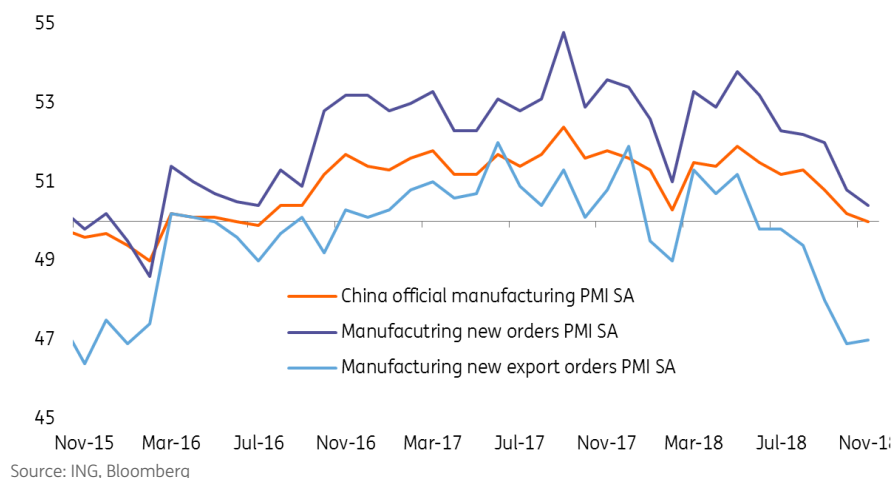


Source: Shutterstock

Manufacturing PMI at the brink of 50

Manufacturing activities did not grow in November despite local governments having raised funds for infrastructure projects. New orders grew slower to 50.4 in the month, down from 50.8 a month ago. New export orders were still gloomy at 47 but edged up from 46.9. It shows that stimulus on infrastructure projects has come in later than expected.

Slower new orders show stimulus was slow to get into the economy



But stimulus from local governments should arrive soon

The come back of local government financial vehicles should mean that stimulus via infrastructure projects is on the way. But it seems that some of the funds could have been used for debt repayments, and have yet to get new infrastructure projects up and running. But with the massive issuance of debt from local governments, via local government financial vehicles and local government special bonds, we expect stimulus will be more obvious in adding manufacturing activities from December.

We also expect that the government is going to cut import tariffs on more goods. This will reduce production costs in the manufacturing sector.

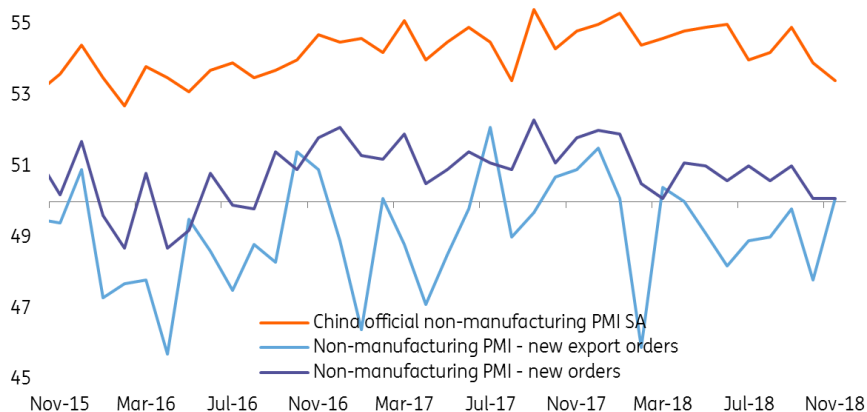
But we expect new export orders to keep contracting as long as the trade war continues, not to mention that the trade war tension could escalate after this weekend's meeting between President Xi and President Trump.

Non-manufacturing PMI shows that consumption is slowing but it should be temporary

A slowdown in non-manufacturing activities is a concern. Catering and real estate services were in contraction [according to the Statistic Bureau](#). Shrinking real estate services, a result of a fall in housing market transaction volume will continue in the coming months until more local governments relax tightening measures.

The contraction of the catering service is a surprise to us. It reflects that consumption is falling. But this could also be temporary as an expansion of activities in financial services, including insurance activities that back up loan growth, could provide a lifeline to private companies, which will secure jobs, and therefore consumption.

Non-manufacturing PMI falling steeper than expected



Source: ING, Bloomberg

Overall, we are not pessimistic

As fiscal stimulus is on the way, we believe that both manufacturing and non-manufacturing activities should be steady from here. Our estimate of the size of fiscal stimulus is around CNY9-10 trillion for late 2018-2020, ie, averaging CNY4 trillion each year in 2019 and 2020.

Though some fiscal money will be used for debt repayment and loan rollovers, the rest will go into infrastructure projects, which will support manufacturing activities, even if the trade war continues to escalate.

Financial and insurance activities for lending and insurance to back up loans will support non-manufacturing activities.

As such we keep our GDP forecast at 6.3% in 2019 from 6.6% in 2018.

Japan: Ready to bounce back

Economic growth in Japan contracted in the third quarter, hit by extensive damage from typhoon Jebi. But the doors are now open for a fourth-quarter...



Source: Pexels

Jebi wreaks havoc on 3Q18 GDP figures

Typhoon Jebi made landfall over Shikoku and then the Kansai region of South Eastern Japan on 4 September, before tracking North West in the direction of Taiwan and Far East Russia. Jebi was estimated by one source as being the most powerful storm on the surface of the planet so far in 2018. It was the most intense tropical cyclone to hit Japan since Typhoon Yancy in 1993.

At peak intensity, Jebi was a Category 5 super Typhoon, with sustained wind speeds of 195km/h, and gusts of 280km/h.

Extensive capital losses and infrastructure damage caused a September slump

Damage from the typhoon was extensive. Flooding and winds wreaked havoc with infrastructure. Roads airports, bridges and ports were wrecked. Private residential property damage was extensive. Hundreds of cars were picked up and tossed to destruction by the winds. Not surprisingly, many businesses suffered capital losses, and many others were shut as staff were unable to reach them. Total insured losses for the economy have been estimated at between JPY340 and JPY620 billion (up to about 0.1% of GDP). But according to some estimates, uninsured agricultural damage may have been up to ten times as large, with other uninsured losses probably

of a similar magnitude.

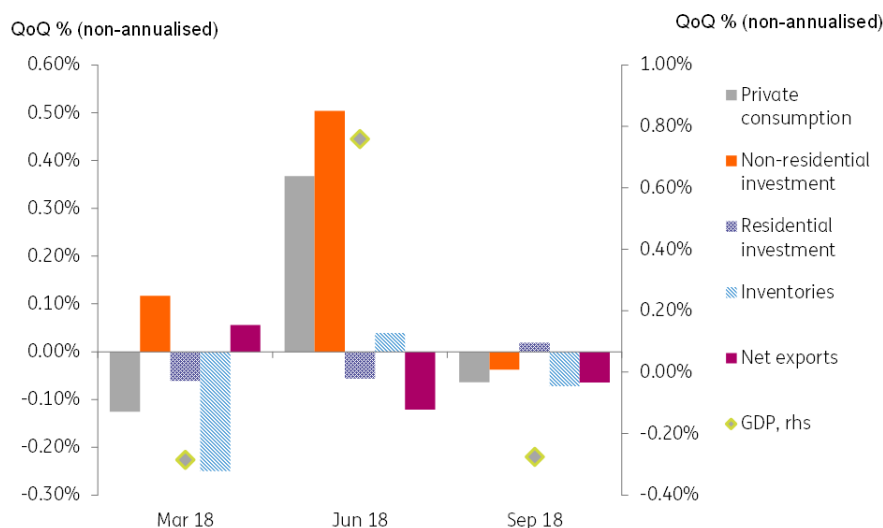
GDP contracted 0.3% QoQ in 3Q18

Our forecasts for third quarter GDP prior to Jebi had been quite strong, at about 2.2% (quarter-on-quarter annualised). Initial indications were that the economy had weathered the Typhoon well. But data released just prior to the GDP figures showed this was not the case. Private household spending dropped very sharply. Business investment was also badly hit, as were exports (though so too were imports). Nonetheless, we still thought there would be some offset in terms of an unintended inventory build as activity that should have happened didn't. The official GDP figures released suggested oddly that this did not happen – possibly inventories were damaged / lost in the Typhoon. The net result was a 0.3% quarterly GDP contraction or -1.1% QoQ in seasonally adjusted annualised terms.

But Japan will bounce back, with stronger growth in 4Q18 and 1Q19...

The common pattern with a natural disaster hitting an economy is real time economic disruption, followed in subsequent quarters by a bounce back, as clean-up spurs activity that would not ordinarily have happened, bolstered also by replacement of damaged capital and infrastructure. The net result on GDP is often (though not always, depending on the extent of infrastructure damage) positive. We imagine that this will be the case this time round too, and have nudged up our 4Q18 and 1Q19 GDP estimates, in response providing a little lift to the 2019 annual growth estimate, which now stands at a healthy 1.7%.

GDP gets wrecked by Typhoon Jebi



Source: CEIC, ING

Inflation spikes should also be limited by oil price declines

Near-term inflation in Japan could also be affected, in particular, agricultural damage should push up headline inflation rates as fresh food prices in Japan and across the Asia region spike higher. But against this, we also have to factor in the much sharper falls in oil prices that have coincided with this event, and which will mitigate against some of this food price increase. In the very short-term,

this may limit the quarterly impact on headline inflation rates. And core rates are likely to remain subdued at close to their current 0.4% year-on-year rate.

The BoJ will find it harder to make any near-term progress towards a taper

None of the above makes it easier for the Bank of Japan to further its attempt to follow the ECB and begin a taper of its own with respect to asset purchasing and bond yield targeting. 10Y JGB yields are back smack on their 0.1% target, and there is no sense that further taper progress is possible near-term. This is not helped, of course, by the macro and political difficulties being faced in the eurozone right now, which limit progress that can be made there, and which therefore deprives the BoJ of a screen for its own intentions.

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Korea: The central bank hikes policy rate by 25bp

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Source: Shutterstock

1.75%

As expected

The BoK policy rate

Up by 25bp today

A 25bp BoK policy rate hike

The Bank of Korea's Monetary Policy Board voted to increase the Base Rate by 25 basis points (bp) to 1.75% at their meeting today. The rate hike doesn't come as any reprieve to the Korean Won (KRW) from its recent underperformance vis-à-vis Asian currencies. Despite the rate hike, the USD/KRW spiked above 1123 in early trading today, though as of this writing the pair had retraced to Thursday's closing level of 1119.4.

The worsening export prospects as signalled by the recent rout in global technology shares

will likely cap the upside for the currency while the rate hike won't be conducive for growth when inflation remains well-anchored around the BoK's 2% comfort level and is likely to track the global oil price lower. That said, the risk to our view of the USD/KRW spiking to the 1150 level in the near term remains skewed to the downside.

Not a unanimous decision

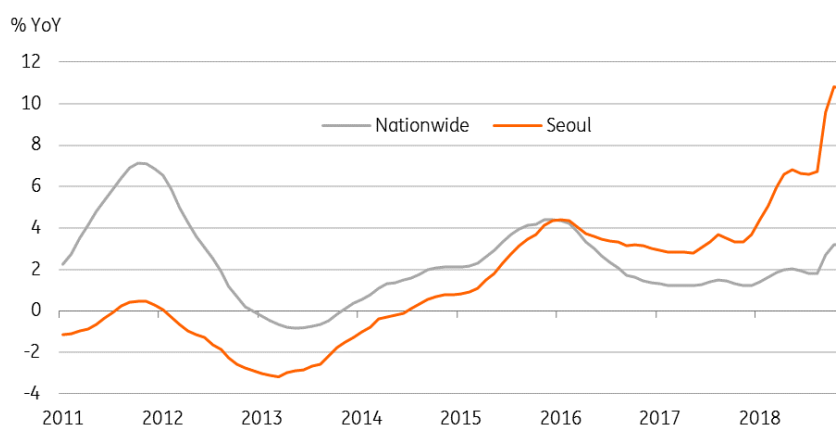
The rate hike, coming after a year-long pause, was widely expected, though we were sceptical of such a policy move just yet on grounds of anaemic growth and low inflation. These trends are likely to persist through 2019 amid intensified global trade tensions and lower oil prices. And indeed the decision wasn't unanimous by all BoK policy board members; two out of seven board members favoured no change to the policy rate.

It appears that financial stability, rather than the current growth-inflation dynamic, was the paramount factor behind today's policy move. Maybe gaining some policy space to increase accommodation in the event of a significant slippage in growth in the future was another factor.

The financial stability concern arose from the widening rate gap with the US as the Fed continues on the policy tightening path with another rate hike expected in December, albeit recent Fed signals of a more flexible approach towards the policy in 2019. This partly explains the recent underperformance of the Korean Won (KRW) vis-à-vis Asian currencies despite a persistently large external trade surplus.

And on the domestic front, the authorities have repeatedly voiced their concerns about high household debt and property overheating in cities as being potentially destabilizing.

Korea: Kookmin Bank home price index



Source: CEIC, ING

Was the rate hike warranted?

The BoK sees growth around the mid-to-upper 2% range and inflation around the mid-to-upper 1% range. On growth, the policy statement noted that "...domestic economic growth to be generally consistent with the path projected in October, and to sustain a rate that does not diverge

significantly from its potential level”.

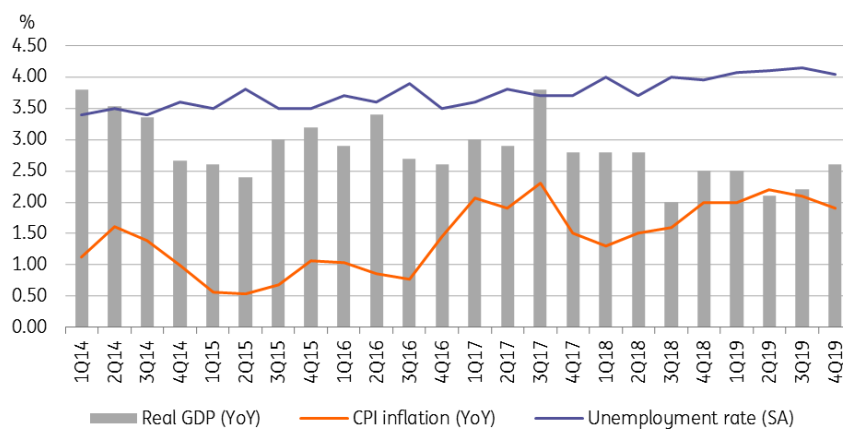
While the BoK’s forecast ranges for growth and inflation appear reasonable for now, the risk continues on the downside.

We consider the BoK’s growth forecast for the outer years, in this case, 2.7% forecast for 2019 as in the central bank’s quarterly Economic Outlook report published in October, as its estimate of potential growth. Judging by this, the 2% growth print for the third quarter of this year was a far cry, and it had taken the steam out of the rate hike argument. Moreover, growth has been stuck under 3% since 4Q17 and it will take a significant acceleration to at least 3.2% in the final quarter of this year to meet the full-year 2018 forecast of 2.7%. As things stand currently, this looks difficult to us.

At the post-policy press conference, Governor Lee Ju-yeol downplayed risks about a sharp downturn in the chip (semiconductor) sector. Korean electronics exports have outperformed their Asian counterparts (Taiwan, Singapore) this year. However, the recent rout in global technology stocks is a sign of something more than mere moderation in the global electronics cycle on the horizon. If so, the prospects of Korean electronics exports maintaining their current strength into 2019 looks dim.

And on inflation, we believe it’s close to the peak and expect it to retrace alongside the lower oil price.

Korea: growth, inflation, and unemployment



Source: Bloomberg, CEIC, ING
ING forecasts from 4Q18 to 4Q19

One and done - a start of another long policy pause

We believe today’s rate hike resets the BoK policy for yet another long pause. Governor Lee said that the policy was still accommodative and the policy rate still below its neutral level. However, his remarks about dissenting votes as pointing to high economic uncertainty indicate a persistent headwind for the policy rate to reach the neutral level anytime soon.

We are reviewing our forecast of one 25bp hike in the third quarter of 2019.

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