

## Good Morning Asia - 3 June 2019

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## Another day, a lower bond yield

US 10Y Treasury yields drop to 2.12%, and equities also retreat in what looks like another trade war defined market moment



### The trade war, not macroeconomics is driving markets

I might as well stop doing my job. All I need to know, to decide whether or not Treasury yields are going to go up, down or stay put, is to know which way the trade war will turn next. At the moment, I don't even need a lucky coin for that. Casual observation shows that the trade war is alive and well, and that China, far from being cowed by the recent Mexican tariffs, seems to be thinking of new ways to retaliate. Published white papers on the trade war over the weekend, the publication of unreliable entities and an investigation into FedEx shows that China is not about to roll over.

The more this trade war goes on, the bigger the tariffs, the more global it's spread, the bigger the dangers. I have been very dismissive of global recession fears in the recent past. The trade war is the single thing that I think has the potential to deliver that outcome. We aren't there yet, perhaps not by a long way, but I am far less sanguine than I was.

As far as markets go, the self-reinforcing equity sell-off, bond market rally, equity sell-off shows no signs of abating. And the circuit breaker for this has to be some movement on the trade war. That isn't evident yet. With the US President Travelling through Europe this week, including Brexit-ravaged-Britain, his mind will most likely be on other things. I don't see China making the first overtures towards peace.

The USD is looking a bit weaker, not just against the EUR, but also some Asian currencies. On a longer time frame, this just looks like the top-end of the current downtrend and nothing too out of the ordinary. That downtrend (USD getting stronger) remains in place, but the current rules of the trade war, which would normally benefit the USD as the US ramped up its trade aggression, may

be coming under strain as bond yields fall this low. This is worth watching, we might have to rethink the way this works shortly.

## RBA Watch - we are not alone

This week, we hope to make up for last week's Bank of Korea disappointment by getting at least one central bank call correct. Sure, the BoK decision did have one dissenter, but Governor Lee Ju-yeol's comments were decidedly hawkish still, so a July cut is by no means a done deal despite dreadful export numbers over the weekend (-9.4%YoY) . We continue to believe that lower rates, sooner rather than later, will save the BoK from having to do more in the longer run and that the focus on structural issues like household debt should be addressed better with macroprudential measures, rather than with cyclical tools like rate policy.

We are in much better company on the RBA call, where all but two of the consensus are also looking for a cut on Tuesday (incidentally, Australian household debt is also very high). This probably will be the first of several cuts from the RBA. The question is, how many, and how quickly? That is the question the market will want to be answered from the press briefing, though we almost certainly won't get a straight answer. For more on this and the implications for the AUD, [please see our RBA preview piece put out last week.](#)

## Asia Day ahead

Japan has already released capital spending figures for 1Q19, and like much of the recent Japanese newsflow, it has been rather better than we might have expected and suggest that 1Q19 GDP may buck the regional trend and show some decent growth. The JPY is looking considerably more resilient as a result, coming close to 108 against the USD.

Its PMI day for much of the rest of the region, including the Caixin PMI for China. Following last week's fall in the official manufacturing PMI, these numbers take on more significance.

PMI's also dominate the G-7 calendar, including the US, where the manufacturing ISM is released. This has been falling on balance since the middle of last year. Last month saw a big fall, and this series tends to saw-tooth from one month to the next, which explains the consensus expectation for a small bounce. The real story is, however, of a slowdown in US manufacturing.

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## ASEAN Morning Bytes

General market tone: Risk-off. Escalation of President Trump's trade war beyond China sustains the global risk-aversion



### EM Space: The threat of global trade war sustains risk-off tone

- **General Asia:** Last Friday Trump threatened a 5% tariff on all Mexican shipments into the US from next week should Mexico not take measures to stem illegal migration. The US also removed “developing nation” privileges from India, effectively slapping a tariff on Indian shipments and opening up a fourth front in the trade war. With the trade war spreading across the globe, risk off tone will likely dominate.
- **Malaysia:** April trade figures due today are expected to signal a weak start to the economy in the second quarter. We consider consensus of about 2% YoY fall in exports subject to asymmetric downside risk. The finance ministry reported that the government debt fell to 75.4% of GDP in 2018 from 79.3% in the previous year as they cut back spending on investment projects by the previous government.
- **Indonesia:** S&P raised the nation's foreign currency rating to BBB on the back of positive growth prospects and given the relative stability on the political front. Incumbent President Jokowi won a fresh term after the recent election which would help him push forward with his reform agenda which could, in turn, attract fresh capital flows.
- **Philippines:** Bangko Sentral ng Pilipinas (BSP) Governor Diokno “promised” to cut both the policy rate and reserve requirement ratios (RRR) in the coming months as inflation decelerates. The dovish Governor did, however, indicate that the timing of such moves would be data-dependent.

## What to look out for: Trade war developments, Fed speakers, US NFP

- Taiwan PMI manufacturing (3 June)
- China Caixin PMI manufacturing (3 June)
- Malaysia trade (3 June)
- US ISM PMI manufacturing (3 June)
- Fed Daly and Quarles speak (3 June)
- South Korea GDP and inflation (4 June)
- Thailand inflation (4 June)
- Euro zone inflation (4 June)
- US factory orders (4 June)
- Fed Williams speaks (4 June)
- Philippine inflation (5 June)
- Australia GDP (5 June)
- China Caixin PMI services (5 June)
- Taiwan inflation (5 June)
- US ADP employment (5 June)
- Fed Clarida, Bowman, Bostic (5 June)
- Euro zone GDP and ECB meeting (6 June)
- US initial jobless (6 June)
- US NFP (7 June)

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# China is preparing to retaliate harshly on the trade and technology war

The Chinese government has issued its trade white paper. China is going to build its own "unreliable entity list", and investigate why mail is being diverted to the US. The Defense Department also has warned the rest of the world not to cross the line on Taiwan to avoid war. These series of actions are the start of Xi's "long march".



Source: Shutterstock

## China is taking a harsh stance on the trade and technology war.

From last Friday to Sunday, China has taken a series of actions to protect its trade and technology companies:

1. China is going to build its own "unreliable entity list", which we expect will be similar to the US "entity list" in the way that it blocks out foreign companies from doing business with domestic firms.
2. China has issued its trade white paper, summarising the points of China's reaction to the US' "unrespectful" terms in the draft trade agreement. This means China will only go back to negotiation if the US removes those "unrespectful" terms.
3. China's Defence department has warned of military actions with respect to Taiwan if any foreign countries cross the line.

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*"The series of actions over the weekend means that China's "long march" has begun. We take this seriously. It means that the trade war has not only become a technology war but also a broadbased business war. "*

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## **The harsh stance means that President Xi's "long march" has begun**

The series of actions over the weekend means that China's "long march" has begun. We take this seriously. It means that the trade war has not only become a technology war but also a broad-based business war. There will be more retaliation actions from China, especially for the technology sector.

On military war with respect to Taiwan, we believe that this is a bit distant. But we are not dismissing the warnings of war out of hand.

## **Bad news for the asset market in the short term, but positive for negotiation in the longer term**

We can imagine that asset markets will react quite negatively to China's actions over the weekend. This is especially so for the creation of the "unreliable entity list" which will hurt corporate earnings directly if a US company is included in the list.

But these actions could be viewed as putting China back onto a level playing field. The US should now know that suppressing China will result in bounce-back retaliation from China. Whether this will encourage the US to go back to the negotiation table is hard to gauge.

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# India: Where is Modi's pre-election boost to economy?

Five-year low GDP growth and escalation of trade risks lead us to downgrade our growth outlook for FY2019-20 to 6.6% from 6.8%. Still, we find it hard to justify yet another central bank policy rate cut this week



Source: Shutterstock

**5.8%** GDP growth in 4Q FY18-19

Worse than expected

## GDP growth hits 5-year low in 4Q FY18-19

India's economic growth slowed sharply in the January-March quarter, the final quarter of the fiscal year 2018-19. Gross domestic product (GDP) grew by 5.8% year-on-year - a significant underperformance relative to the consensus median estimate of 6.3% growth (ING forecast 6.0%), and down from 6.6% in the previous quarter. This was the weakest economic performance since the Modi government came to power five years ago.

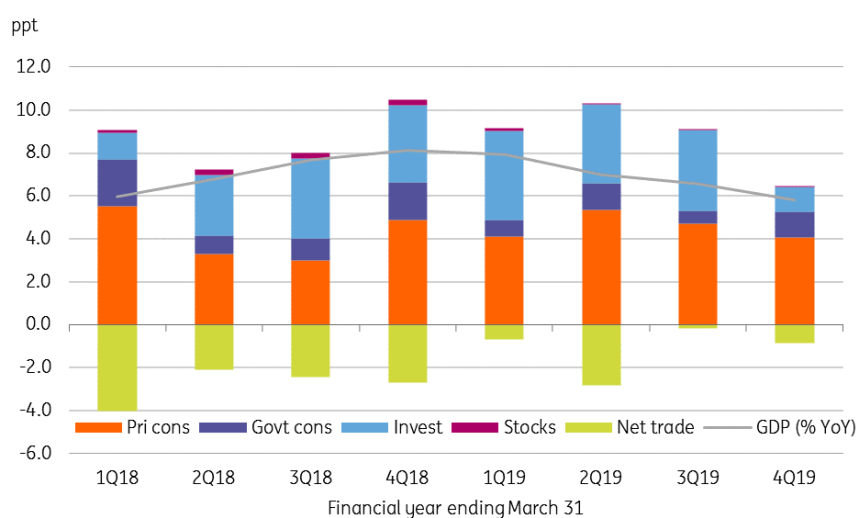
Investment, with a sharp slowdown in growth to 3.6% YoY from 11.7% in the previous quarter, was the biggest drag on GDP growth. Not just that, the contribution of private consumption and net

trade also weakened. On the flip-side, growth of government consumption more than doubled, thanks to election spending. By sectors, agriculture and manufacturing stood out as the main sources of GDP slowdown.

In addition to these factors, the authorities blamed prevailing problems in of non-bank finance companies (the shadow banking sector) for the economy's slowdown, and they expect the resultant liquidity and lending headwinds to growth to continue to overshadow the growth prospects in the current quarter.

This puts annual FY2018-19 growth at 6.8%, down from 7.2% in the previous fiscal year and also the slowest in the last five years.

## Expenditure-side sources of GDP growth



Source: CEIC, ING

Bars may not stack up to total GDP growth due to statistical discrepancy.

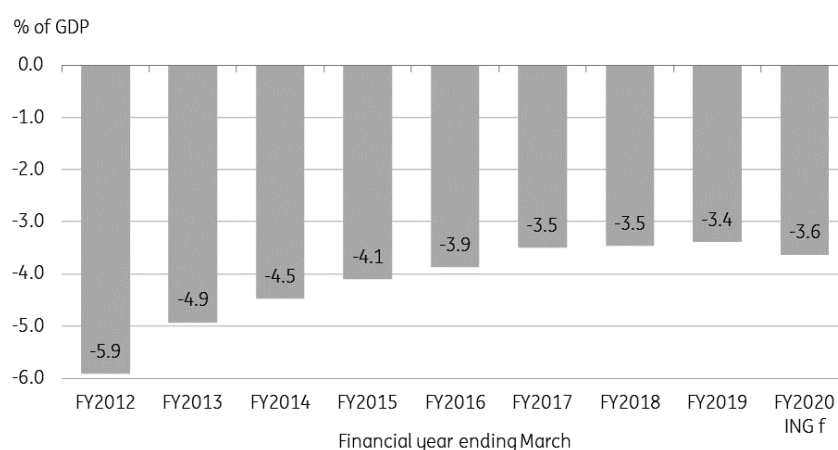
## The pre-election fiscal boost failed to support growth

The economy tanked despite all the fiscal boost it received before the general election. Released alongside GDP on Friday was data on public finances showing on-target FY2018-19 fiscal deficit of INR 6.45 trillion (3.4% of GDP), though the target was revised higher from INR 6.2 trillion (3.3% of GDP) in the interim budget or vote of account before the elections.

And even though this was slightly better than the 3.5% deficit in the previous financial year, we don't think there is enough here to credit the government's fiscal management. The annual revenue growth of 7.4% was little changed from the previous year despite the streamlining of the Goods and Services Tax, while there was a significant acceleration in capital spending growth to 15.4% YoY from -8.3%.

We expect weak public finances to continue to weigh on investor sentiment this year. Even as the government aims to maintain the deficit at 3.4% of GDP in FY2019-20, the risk of another overshoot remains high as the Modi administration will likely be spending the rest of the year in fulfilling its election promises. Look out for Modi's newly appointed finance minister, Nirmala Sitaraman, unveiling the final budget in about a month (5 July).

## Government budget deficit



Source: CEIC, ING

## From political to trade uncertainty

The economy ended the FY2018-19 on a weak note, which clouds the prospects for the following year.

Indeed, the first quarter of the current fiscal year was hampered by political uncertainty. And just as the economy was about to take some breather from the political uncertainty, the external uncertainty of the US President Trump expanding his battlefield of the trade war to India has gone up sharply.

The US Treasury in its latest report removed India from the monitoring list of countries suspected of manipulating their currencies for export advantages, but President Trump has just proclaimed India to be out of the developing countries enjoying trade benefits under the generalised system of preference (GSP).

The intensified economic risks, both domestic and external, lead us to downgrade our forecast of GDP growth for the current fiscal year to 6.6% from 6.8%.

**6.6%** ING's GDP growth forecast for FY19-20  
A downgrade from 6.8%

## Still, no strong case for central bank easing this week

The steeper-than-expected slowdown in economic growth in the last quarter doesn't really strengthen the argument of the Reserve Bank of India continuing to ease the policy at the meeting scheduled this week (Thursday, 7 June). This may sound a bit odd.

However, a prudent and proactive policy shouldn't be reliant on historical data in the first place. Secondly, the RBI has already cut rates twice in the current quarter and has been supporting the banking system liquidity through its open market purchases and swap auctions (USD/INR swaps).

This should prove to be sufficient monetary policy thrust for an economy that's also potentially facing a significant inflation risk from supply shocks to food and fuel prices.

Negative agriculture GDP growth in the last quarter foreshadows higher food prices in the future, while a supply shortage due to the US sanctions on Iranian oil poses the risk of higher fuel prices. Loose fiscal policy and a weak currency are among other factors contributing to higher inflation in the future. While we don't see these inflation risks materialising just yet, excessive policy loosening could backfire with a steeper inflation spike amid already elevated inflation expectations.

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# Indonesia: S&P raises credit rating a notch to BBB

S&P grants Indonesia a rating upgrade after President Jokowi secures a fresh term



Source: Shutterstock

## S&P lifts Indonesia's rating after Jokowi secures fresh mandate

S&P raised the nation's foreign currency rating to BBB on the back of positive growth prospects and given the relatively stable policy environment. With the elections out of the way and Jokowi looking to prime the economy for faster growth, the rating agency believes that economic expansion in Indonesia will outpace that of its peers. Jokowi is reported to be reconstituting his cabinet with an eye to driving growth forward via investment while relatively low inflation will help boost household spending in 2019. Robust momentum, coupled with likely improved capacity through infrastructure investment, will likely help Indonesia attract more capital flows in the medium term.

## Upgrade to provide a boost but trade war persists

The S&P upgrade has helped to provide a nice lift to the 10-year Indonesian bond (+0.35 of a point) while the currency enjoyed a quick 0.78 appreciation versus pre-upgrade levels of 14380. But while growth prospects remain favourable given Jokowi's fresh impetus for investment, concerns about the external position remain given Indonesia's perceived susceptibility to the US-China trade war. With lingering concerns about the current account deficit, pressure on the Indonesian rupiah may remain, albeit at a less pronounced pace, which should keep Bank Indonesia (BI) on its toes and the central bank likely on hold for the time being.

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