Good MornING Asia - 30 April 2018

A promising start to talks between North and South Korea has done little to lift market mood

In this bundle

South Korea

A curious turn of events

A promising start to talks between North and South Korea has done little to lift the market mood

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China: Revising our yuan forecast

We are revising our yuan forecast to a milder appreciation in 2018 and 2019 because of a weaker business environment and escalating trade and investment...

Japan

BoJ tweaks its statement - this could be important

The Bank of Japan (BoJ) has removed any reference to reaching its 2% inflation target by some time around fiscal 2019 in its latest statement - this can...

Indonesia

Indonesia: Central Bank turns hawkish

Bank Indonesia has turned hawkish and is now open to a rate hike, like other Asian central banks which have seen their currencies weaken substantially

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Philippines: S&P upgrades outlook to positive

The upgrade reflects the relatively strong external payments position and reforms in the financial and fiscal sectors that enhance the country's...

A curious turn of events

A promising start to talks between North and South Korea has done little to lift the market mood

Unexpectedly good start, but little market response

The photo shoots from Korea at the end of last week were at the extreme end of positive. Had you asked me at the beginning of the year for upside scenario shocks to the global economy, I would have struggled to add, "peace breaks out between N and S Korea" to the list. That isn't quite there yet, but the possibilities seem better than before. Is it just me though, but does the prospect of President Trump meeting Kim Jong-Un cause anyone else to get jittery? The two are due to meet within the next three to four weeks, and Trump's language, though toned down, is still on the aggressive side, threatening to walk out if he doesn't get what he wants, which is complete denuclearisation. North Korea has said it will shut down its nuclear testing site and will do so with international observers present. Though some have already suggested that the testing site is already damaged beyond repair and that North Korea is simply capitalising on that accident. Whatever the truth, things do seem to be headed in the right direction. All that is missing is some more positive response from markets. The Korean won is showing little sign of euphoria, though it isn't weakening either. 10-year Korean government bonds are a bit more responsive, with the yield down about 5 basis points to a little under 2.70%.

Fed ahead

US Treasury yields have retreated a little further from the 3% mark, but remain within spitting distance, and that hurdle may be more decisively crossed this week. Factors that should help

markets to cross the line include Friday's US jobs report and Thursday's FOMC decision. The FOMC meeting is not a press briefing meeting, so rates will probably be left on hold, though the statement's tone could leave little doubt about further imminent rate rises, which could help lift yields. A bounce back in job creation is also likely, as too is a slight increase in the wages component of the report. Together, these two releases have the potential to see a 3.0% yield achieved and exceeded. Profit-taking in the extreme speculative short Treasury positioning in futures markets could see further fresh selling in the spot market to push yields higher still.

Day ahead

It has been a bad start to the day in Asia, with poor industrial production figures out of Korea for March. These come on the back of poor figures in February too and production is now 4.3% lower than the same month a year ago. There was better news from Korea's service sector, which accelerated from 1.9% year-on-year in February to 2.3% in March. And consumer goods sales were also strong. Old-style fiscal stimulus implemented last year by the current government does seem to be paying off, with weaker activity in the goods-producing sector offset by stronger domestic demand. That may be working for Korea, but we think the problems on the manufacturing side are a broadly spread Asian issue, and not every country has been as far-sighted as Korea.

Thailand releases manufacturing data later today.which will throw a first glance at how 1Q18 Thai GDP is shaping up. The Thai story has been almost the reverse of Korea's, with strong exports and output, but weak domestic demand. We would have no issues with the Thai story converging on the Korean one.

Today's main Asian release may be China's PMIs, with non-manufacturing and manufacturing indices both released. Consensus expectations are for some slight moderation in both - a combination of trade tensions and deleveraging weighing on activity in the first quarter.

There seems to be little lingering effect on the Japanese yen of last week's Bank of Japan statement (see also our note on this from the end of last week). We may have to wait for the minutes of the last meeting on 7 May for a further explanation of what, if anything the BoJ is planning to do with its quantitative and qualitative Easing Program.

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China: Revising our yuan forecast

We are revising our yuan forecast to a milder appreciation in 2018 and 2019 because of a weaker business environment and escalating trade and investment tensions

China's yuan has risen more than 2% against the dollar this year

Chinese yuan not as strong as expected

We have been bullish on the yuan, against the backdrop of a strong economy and with business earnings growing at a decent rate. However, this looks to have changed according to recent data (see below).

Further, escalating tension between China and the US has moved from trade to investment. This could affect business earnings in some sectors negatively.

The trade tension could also lead to shrinking global trade volumes. This would affect not only China but also the supply chain in Asia to a large extent. Asian currencies, in general, may run much flatter against the dollar, requiring the yuan to also flatten its appreciating path to protect competitiveness.

Revising USD/CNY to 6.33 by end of 2018

Based on such thoughts, we revise our forecasts on USD/CNY:

- from 6.25 to 6.35 by the end of 2Q18, and
- from 6.20 to 6.34 by the end of 3Q18, and
- from 6.10 to 6.33 by the end of 4Q18, and
- from 5.80 to 6.20 by the end of 2019.

Under these new forecasts, the yuan against the dollar would still appreciate in 2018 compared to 2017's closing of 6.5067, but at a slower speed at around 3%, and at 2% in 2019.

Thinner profits for factories even before escalating trade tensions

Growth in industrial profits fell to 3.1% year-on-year in March from 10.8% the previous month. But with strong growth in the first two months of the year, growth of industrial profits in 1Q18 was still decent at 11.6% YoY.

Still, we are concerned. Though the number of working days in March was affected by Chinese New Year holidays, which will not repeat in April, the lower selling price of raw materials together with rising financial costs means there are fundamental changes in industrial profits.

Falls in material prices is a result of both the high base effect from last year and an increase in production (it is usual for businesses to produce more when prices are falling to maintain the profit level).

Though we expected rising financial costs in an environment of financial deleveraging reform, the rise in financial costs at 15.1% YoY in March compared to 12.3% YoY in the first two months means that financial cost increases are speeding up. As financial deleveraging reform will continue for the rest of 2018, this could continue.

All in all, we believe that industrial profits could fall from more than 10% YoY to high single digits in the coming months.

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BoJ tweaks its statement - this could be important

The Bank of Japan (BoJ) has removed any reference to reaching its 2% inflation target by some time around fiscal 2019 in its latest statement - this can be interpreted in a number of ways - read on to see which we prefer

Kuroda's linkage of the end of QQE to the inflation target is still haunting him

At a press conference a month or two back, Bank of Japan Governor Haruhiko Kuroda made a link between the end of Qualitative and Quantitative Easing (QQE) and the BoJ achieving its 2% inflation target sometime in 2019. Since then, markets have been wondering if the BoJ was quietly working towards an exit strategy based on this time horizon. Indeed, whilst inflation data were heading higher earlier this year, you could make a case for the BoJ gradually cutting back on its asset purchases, perhaps under cover of similar moves by the ECB to end its QQE purchases by mid-2019. The obvious advantage of such "stealth-unwinding" would be that it would moderate the currency impact on the Japanese yen.

But whilst the growth data for Japan remains pretty good, the same can't be said of the Eurozone, where 1Q18 delivered a notable soft patch on activity. Moreover, both economies have seen disappointing inflation data recently. So extrapolating from today's run of recent data to less

accommodative monetary policy over any sort of reasonable time span is looking very tough for the ECB, and by extension, equally tough for the BoJ.

So did today's statement change that at all?

What? No inflation target forecast?

With no change to policy and little change to the growth or inflation forecasts, the only thing for markets to focus on was the omission of the forecast that the inflation target (2.0%) would be met sometime around fiscal-year (FY) 2019.

There are a number of ways you can interpret this. Here are two:

1. The BoJ acknowledges the recent softness in inflation, persistent lack of inflation upturn and low probability of meeting its target on the previous timeframe. As a result, the BoJ has dropped it. This would also imply a much lower probability of an end to QQE by mid-2019.
2. The BoJ realises the low probability of meeting its 2% target - but also downgrades this as an intermediate target, as the rest of the economy looks in good shape - arguably, this could result in an earlier or unchanged exit strategy for QQE. 2% was always an unrealistic target and dropping the reference merely gets rid of something that was harming credibility.

The ensuing press conference has sought to downplay the significance of this statement change. With the basic message coming out that this was just a "forecast", and not a limit, and that monetary policy was not being determined on a calendar basis, but according to conditions. Together with a downgrading of the balance of risks to the inflation outlook, it looks to us as if there is more truth to scenario 1) than to scenario 2). If so, then we might also expect the JPY to run softer than we have been forecasting.

That said, there is still plenty of ambiguity over this decision, and ongoing problems for the BoJ in meeting its asset purchase targets or maintaining Japanese government bond yields at zero percent. So finding an exit strategy would not be a bad idea. Today's move may be the first in a very long series of changes designed to achieve that.

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Indonesia: Central Bank turns hawkish

Bank Indonesia has turned hawkish and is now open to a rate hike, like other Asian central banks which have seen their currencies weaken substantially

4% IDR weakness year-to-date

BI policy rate hike is likelier as direct intervention in IDR spot market may not be enough.

We have warned in earlier notes that a weakening Indonesian rupiah could see Bank Indonesia (BI) turn more hawkish. BI, like the Philippine and Indian central banks (BSP and RBI), indeed turned hawkish. BI declared its openness to hike policy rates yesterday, earlier than we had expected. The IDR has weakened by as much as 4% year-to-date while the Indian rupee and Philippine peso have lost as much as 5% against the US dollar. Prolonged currency weakness, especially when it comes with higher commodity prices, leads to higher-than-expected inflation and raises the risk of lower household spending, moderate economic growth and a less stable financial sector.

Perceived central banks' complacency in the previous weeks added to the currency woes, which already reflect current account deficits, higher oil prices, increased risk of slower growth and

US monetary policy tightening. Direct intervention in the spot market has moderated the recent weakness but this is unsustainable and could eventually exacerbate the weakness of the currencies as FX reserves dip. The market sees monetary policy hawkishness as a way to protect the economy, inflation targets and the financial sector. BI targets inflation between 2.5% and 4.5%. However, inflation is already expected to increase in the coming months with the consensus forecast at 3.7% this year from the actual 1Q average of 3.3%. We expect inflation to average 3.6-3.7% for the rest of the year. Markets fear that the sustained weakening of IDR may yet lead to higher inflation expectations. BI's recent openness to a rate hike coupled with sustained IDR weakness could see a policy rate hike as early as this quarter or in 3Q.

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Snap | 27 April 2018

Philippines: S&P upgrades outlook to positive

The upgrade reflects the relatively strong external payments position and reforms in the financial and fiscal sectors that enhance the country's strong growth path

Source: Shutterstock

The likelihood of an upgrade to BBB+ in 12 to 24 months is high

S&P last night upgraded the Philippines sovereign credit outlook to positive while affirming its BBB rating. This was due to a relatively strong external payments position and policies that enhance the country's fiscal sector and prospects for balanced and strong growth. S&P recognises that the current account will be in a slight deficit through 2021. The market expects a current account of -0.7% of GDP this year before receding to -0.1% of GDP by 2020. We are less optimistic and expect the widening trade gap in the next five years to lead to an average current account of -1.2% of GDP (with an average GDP growth of 6.8%). Investors would likely regard the expansion of the country's domestic capacity and potential output as outweighing a moderate deterioration of the current account.

The outlook upgrade recognises a more important development; that the monetary and fiscal policy environment has improved. Financial and fiscal reforms are positive strides toward a higher growth path and a more sustainable fiscal sector. Notwithstanding the inflation pain that the recent tax reform temporarily inflicted on the economy, the reform measure has enhanced

revenues, allowing the government to pursue accelerated infrastructure spending and enhanced fiscal stimulus. A more solid execution of the infrastructure programme would be favourable. Monetary policy reforms also cut intermediation costs and enhance financial stability. We believe that the continued pursuit of such reforms would be successful and avoid downside risks to the country's credit rating.

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