

Good MornING Asia - 30 June 2020

Investors will take their cue from manufacturing data while keeping an eye on Covid-19 developments

In this bundle



Asia Morning Bites

ASEAN Morning Bytes

Investors will take their cue from manufacturing data while keeping an eye on Covid-19 developments.



FX | China

China: Industrial profits show recovery

Industrial profits had a U-turn to growth from a falling trend. This could be the first sign that China's manufacturing sector is recovering. But...



China

Hong Kong: Impact of losing special status from US

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India

India heads into a deeper economic slump as Covid-19 crisis worsens

The accelerating spread of Covid-19 and insufficient fiscal policy stimulus prompts another downgrade to our forecast of India's GDP growth in the...

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China's PMI data could give additional direction on Tuesday

- **General Asia:** Concerns continue to mount over the acceleration in Covid-19 new daily infections in the US while Fed Chair Powell highlights the importance of containing the virus as the economy attempts to bounce back. Meanwhile, geopolitical tensions continue to simmer with the US removing certain trade benefits extended to Hong Kong given China's recent imposition of security measures. Manufacturing data from China will be the highlight for Tuesday's economic data calendar although Covid-19 developments should continue to dominate sentiment with new lockdowns reported in China's Hebei province.
- **Malaysia:** S&P downgrade the outlook for Malaysia's 'A-' sovereign rating from Stable to Negative. The agency pointed to weakening public finances with a risk of net government debt topping 60% of GDP. Weak growth and rising government spending to support the economy are set to widen the budget deficit to more than 6% of GDP in 2020 from 3.4% in 2019. The S&P action follows a similar move by Fitch Ratings back in April. Moody's might soon follow suit. Unfortunately, it's hard to justify such negative actions when economies require aggressive policy support. The MYR should continue under weakening pressure from such news.
- **Thailand:** Balance of payments data for May is due. We expect a second consecutive month of current account deficit (-\$1.4 billion vs. -\$654 million in April), as net outflows on the

services side continue to offset surpluses from merchandise trade (\$2.7 billion on customs basis). Meanwhile, weak exports dragged manufacturing output down by 23% YoY in May, consistent with our forecast of a greater than 8% YoY GDP fall in 2Q20. Despite all the underlying negatives, the THB remains the investors' darling with 3% appreciation against the USD so far in June.

- **Philippines:** Bangko Sentral ng Pilipinas' (BSP) governor indicated that he would likely pause on cutting policy rates for “at least a couple of quarters” although he reiterated that the central bank continued to have ammunition to provide further stimulus to offset the fallout from Covid-19. We expect BSP to refrain from cutting policy rates further which would be supportive of PHP in the near term although a resurgence in import demand coupled with the slowdown in remittances could spark a reversal of the peso's trend.
- **Indonesia:** Finance Minister Indrawati informed parliament that the national government and Bank Indonesia (BI) are finalizing plans for the central bank to purchase government bonds at a discount to help ease the financing burden of Covid-19 efforts. The agreement moves in-line with the previously announced “burden-sharing” agreement with BI expected to purchase up to IDR398 trillion worth of bonds at zero interest to help fund loans to micro, small and medium enterprises. Such a move would help cap any rise in bond yields in the short term although the authorities must outline details for an eventual exit strategy for the bond purchase scheme.

What to look out for: China PMI and Covid-19 developments

- China manufacturing and non-manufacturing PMI (30 June)
- Thailand BoP (30 June)
- US consumer confidence (30 June)
- Fed's Powell testimony before congress (30 June)
- regional manufacturing PMI (1 July)
- Indonesia inflation (1 July)
- US ADP employment, ISM manufacturing PMI (1 July)
- US trade, non-farm payrolls, factory orders, durable goods orders (2 July)
- China Caixin PMI (3 July)
- Thailand inflation (3 July)
- Malaysia trade (3 July)
- Singapore retail sales (3 July)

Author

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

China: Industrial profits show recovery

Industrial profits had a U-turn to growth from a falling trend. This could be the first sign that China's manufacturing sector is recovering. But there are risks to future profit growth



Source: Shutterstock

Passengers cheer up for Wuhan while waiting to take train K81 at Wuchang Railway Station in Wuhan, central China's Hubei Province, late April 7, 2020.

Industrial profits finally show signs of recovery

Profits in the industrial sector finally showed growth in May of 6.0% year-on-year after falling since the beginning of 2020 due to Covid-19.

Costs have been lowered, loss-making firms made smaller losses than before and sales of inventories also helped.

Profitable industries are technology related

The most profitable industries are computers, telecommunications, and other special equipment manufacturing. Profits grew 34.7% YoY year-to-date in May. Such firms also recorded the largest revenues (CNY4.02 trillion YTD) in the sample of the National Bureau of Statistics (overall profits of the sample were CNY36.88 trillion YTD in May).

This is easy to understand as technology-related manufacturing is a high-value-added industry that can withstand production cost increases in China. At the same time, due to increasing costs in land and workers, lower profit margin industries, including textile and garments (profit fell 29.2% YoY YTD in May) and toys (no longer in the sample), have started to move away from China to other Asian economies. This movement trend was in motion even before Covid-19, or the trade/technology war and precedes current talk about diversification of production lines.

But there are hidden risks

One of the reasons behind profit growth in May was lower costs, which is a combination of lower energy costs and wages. This highlights that:

1. global demand is still weak and therefore energy costs are lower;
2. labour earns less than before Covid-19, which could hurt domestic consumption.

Another risk is that the core of profits comes from technology-related industries, which is at risk of a possible re-escalation of the technology war between China and the US. China is trying to become a more self-reliant technology economy, but before that is achieved the technology war continues to be a risk to the industry's profits.

There is hope but not enough to upgrade our GDP forecast

Profit growth is the first sign of the recovery of China's economy. If profits continue to rise, the positive trend could help redundant labour find new jobs and the entire labour market should enjoy higher wages later when the recovery becomes more solid.

Covid-19 clusters have begun to re-emerge in major cities globally, including the US and some European economies, which should continue to put pressure on global demand and therefore China's export sector. We will continue to monitor whether China's recovery can become a trend, instead of just a data point, before we revise our GDP forecasts.

As of now, our GDP forecast for China is -1.5% for the full-year 2020.

Author

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Hong Kong: Impact of losing special status from US

(This note was first published on May 31 this year - its conclusions still hold following the US announcement on restrictions on exports of sensitive items yesterday). The US is stripping Hong Kong's special status under US law. What does it mean from an economic perspective? The focus has been on trade but the impact is more on the use of US technology



A bit of background

Hong Kong is losing its special status from the US, according to Mike Pompeo, the US Secretary of State. But the details are still missing.

The United States-Hong Kong Policy Act in 1992 gave Hong Kong favourable trading terms with the US. This act identifies Hong Kong as a separate customs territory from Mainland China.

Hong Kong's exports to the US were around US\$39 billion in 2019, amounting to 7.6% of Hong Kong's total exports, but down around 15% of the total in 2018. US imports into Hong Kong were around US\$27.3 billion, equivalent to less than 5% of Hong Kong's total imports in 2019, and down about 8% from 2018. These falls in trade flows were mostly due to the trade war between China and the US. As Hong Kong has a very tiny manufacturing sector, its exports are almost all re-exports. We will explain in the latter part of this note how industries are affected by potential trade-related policies imposed by the US.

Direct investment from the US into Hong Kong was US\$37.3 billion as of the end of 2018, which was equivalent to less than 2% of total direct investment into Hong Kong. The increase in investment by the US was US\$2.5 billion in the same year, which was around 2.3% of the total

increase in direct investment. But this amount could be underestimated if US companies invest in Hong Kong through companies registered in other locations, eg, Bermuda and Cayman Islands. For this reason, we will use the number of US companies that have regional headquarters in Hong Kong as a proxy for US investment in Hong Kong.

But first of all, the biggest threat is on the use of US technology.

? Impact on technology

The removal of the special status could mean more restrictions on technology transfers between the US and Hong Kong.

That is because, after the removal of the special status, the same policy applied to Mainland China on technology transfers should, in theory, be applied to Hong Kong. This is "export control" in technical terms. Put simply, the US government can ban US companies from selling technology products and services to Hong Kong-based companies.

According to [the media](#), about 70% of cybersecurity products in Hong Kong originate in the US.

The ban should not be limited to cybersecurity products. It could have a very deep and wide impact on Hong Kong companies and individuals' daily lives, even though technology and innovation is not the key industry of Hong Kong.

Unlike Mainland China, Hong Kong does not manufacture products, so the technology threat is not in terms of producing advanced technology products. Instead, Hong Kong companies provide telecommunication and technological services that rely on technological products. These range from mobile applications that are put on US mobile companies' platforms for the use of US companies' telecommunication products in business and the technology applications for those products.

This will be especially true if the technology products could have dual-use, ie, both commercial use and military use, which is at the core of the technology war between the US and Mainland China. There are many technologies that could have dual-use.

Because the impact could be very damaging, there is some doubt about the stringency with which the US would enforce the special status on technology transfers as this would also hurt US companies and their reputation. We believe more countries will try to find alternatives to US technology from now on as a back-up plan, in case there is a sudden ban on using US technology.

→ Impact on investment

The removal of the special status should not have much impact on investment by US companies in Hong Kong unless there is retaliation in terms of sanctions from Mainland China on US entities based in Hong Kong, which is unlikely. But the trade war between China and the US will be a negative factor for US companies choosing Hong Kong as their regional headquarters.

Many US companies choose Hong Kong as a destination for their regional hub because of the low corporate and individual tax rates and the HKD linked exchange rate system, which is essentially a peg to the USD, that benefits US companies by avoiding FX risks.

Moving out of Hong Kong also means that these companies have to relocate their regional headquarters to other locations in Asia. The uniqueness of Hong Kong's linked exchange rate system is not replicated by other economies in the region. As such, we do not think there will be a large-scale relocation of US companies away from Hong Kong.

US companies are at the top of the list of regional headquarters in Hong Kong. In 2019, Hong Kong had 278 regional headquarters of US companies, equivalent to 18% of Hong Kong's total regional headquarters (1,541 entities). Even so, US companies scaled back their investment in Hong Kong in 2019. These companies include financial institutions, technology companies, and treasury centres of some manufacturing companies. They are important for the financial sector of Hong Kong. Some US companies that have businesses in Mainland China have a funding pool in Hong Kong for better allocation of funds in various parts of their global business.

The trade war has also had an impact on US companies choosing Hong Kong as their regional centre. Some US companies scaled down their investment in China when the trade war and technology war began. There were 4% fewer regional headquarters from the US in 2019 compared to 2018. But even that did not change the landscape of US companies being at the top of the list of those with regional headquarters in Hong Kong in 2019. However, an intensification of the trade and technology war between China and the US could gradually change this landscape. In a few years time, there could be more Mainland China companies headquartered in Hong Kong than US firms.

↓ Impact on Hong Kong trade as a re-export centre

On trade, we focus on the most critical part that could be affected by the removal of the special status.

Most of the media reports have focused on trade, that is Hong Kong's exports to the US, which will then have the same tariff rates imposed as Mainland China's exports. But we have to keep in mind that Hong Kong has almost no manufacturing sector, so it is re-exports that are the key part of Hong Kong's exports of goods.

For example, Mainland China's exports passing through Hong Kong to the US are subject to a tariff rate that applies to Mainland China. That is, in terms of tariffs, there should be no difference in terms of special status.

But there is a "[first-sales rule](#)" that makes Hong Kong more important to Mainland China during the trade war. According to the Hong Kong Trade Development Council, [the use of the first-sales rule has risen a lot](#) since the trade war between the US and China.

- With the first-sales rule, exports to the US that go through more than one location will be charged duties based on the price of the initial sales. For example, when a Chinese exporter sells goods to a Hong Kong re-exporter at a lower price, then the Hong Kong re-exporter (eg, a subsidiary of the Mainland China company located in Hong Kong) sells at a higher price to a US importer, the tariff will be based on the first transaction. As such, the tariff paid could be lowered when there is a throughput via Hong Kong.
- When Hong Kong's special status is removed, a Hong Kong re-exporter might not be treated as a "second leg" of the export to the US. Mainland China's exports will search for another "second leg". As a result, Hong Kong's port and logistic businesses are likely to

experience some decline.

How much are these re-export activities? According to the [Hong Kong Trade Development Council's report in April 2020](#), around 8% of Mainland China's exports to the US, and around 6% of Mainland China's imports from the US, went through Hong Kong in 2018. For comparison, Hong Kong's total exports amounted to US\$533 billion, of which around US\$39 billion was exported to the US in 2018, according to the Census Department of Hong Kong.

Hong Kong's overall exports to the US with the tariff rates imposed on Hong Kong after the removal of the special status will certainly fall due to the absence of the role in "first-sales rule". Again, this damages the port, shipping service and logistic industries. But [these industries have been hurt anyway since the start of the trade war](#) between Mainland China and the US.

GDP growth depends on US policies and China's retaliation

As we said at the beginning, banning the use of US technology is the real threat to Hong Kong when the special status is removed. Businesses related to technology will be hurt if there is a ban on using US technology. The impact can vary a lot in terms of GDP. We need to see the exact policy changes from the US to gauge this damage.

The removal of special status is not going to have a meaningful impact on US companies setting up regional offices in Hong Kong. But the trade war between China and the US has been a negative factor that increases the hurdles of US companies doing business with Mainland China, and therefore the need for a treasury centre in Hong Kong diminishes. This gap will be filled by Mainland China companies. In this sense, the trade war could lead to the Hong Kong economy relying more on Mainland China.

Port, shipping services and logistics will be affected by the removal of the special status, but they are already in bad shape following the trade war between China and the US.

The uncertainty on the Hong Kong economy does not only depend on how the US shapes its policies towards Hong Kong after the removal of the special status, but also on Mainland China's possible retaliation, which could be a mix of economic and political policies toward the US. We may revise our GDP forecast later depending on the policy changes revealed by the US, and also the impact of protests on retail sales and the relaxation of social distancing measures on employment.

For now, our GDP forecast is -4.1% for 2020.

Author

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

India heads into a deeper economic slump as Covid-19 crisis worsens

The accelerating spread of Covid-19 and insufficient fiscal policy stimulus prompts another downgrade to our forecast of India's GDP growth in the current fiscal year to -5.2% from -2.1% earlier



Source: Shutterstock

-5.2%

ING forecast of India's GDP growth in FY20

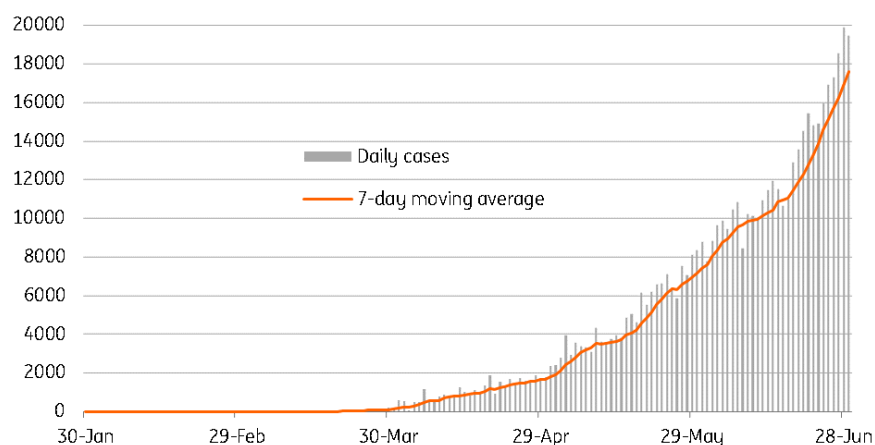
Cut from -2.1%

Worsening Covid-19 crisis

It's now five months since India reported its first Covid-19 case in late January and the pandemic continues to worsen in this country. The total number of infections crossed the half-million mark over the past weekend, with daily new infections continuing to scale new heights; at about 20k confirmed cases currently. The country is now the [fourth worst-affected](#) in the world after the US, Brazil, and Russia.

The seven-day average daily infections are currently running at 17.6k. This number has than doubled in less than a month. So has the total number of infections. There are about 16.5k deaths so far, while 58% of cases are reportedly recovered. All these figures remain debatable though, given the country's poor healthcare infrastructure and weak testing, tracing and isolation efforts. Even so, at such a rate of contamination, it is probably only a matter of time before India moves up into third place globally for total official recorded cases, ahead of Russia.

Daily Covid-19 infections near 20k currently



Source: Worldometers

Wasted lockdowns

India was among the first countries in Asia to begin a nationwide lockdown on 25 March when officially recorded cases touched 500. But lockdown implementation was chaotic; announced just hours before it started, and dragging on with four extensions from the initial three-week phase until end-June.

Despite reportedly being one of the strictest in the world, India's lockdown has failed to break the infection chain. Undermining it was the migrant crisis – workers from largely unorganised sectors in big cities moving back to their native states, many of whom reportedly died during the journey whilst survivors carried the disease back to their home towns and villages. Large slum dwellings in cities like Mumbai became fresh breeding grounds for the virus. This is why we think the actual spread could be far worse than the reported statistics.

We believe fragmented lockdown efforts in the containment zones will be the main approach going forward as authorities are likely to resist another nationwide lockdown considering its far-reaching consequences for the broader economy.

Worst economic slump in decades

We finished a review of our forecast of India's GDP growth in light of the accelerating spread of Covid-19, and available high-frequency economic activity data. Just like the pandemic itself, the economic fallout looks to be the worst in Asia. Nearly a whole quarter of economic inactivity in 2Q20 will mean a significant dent to GDP growth.

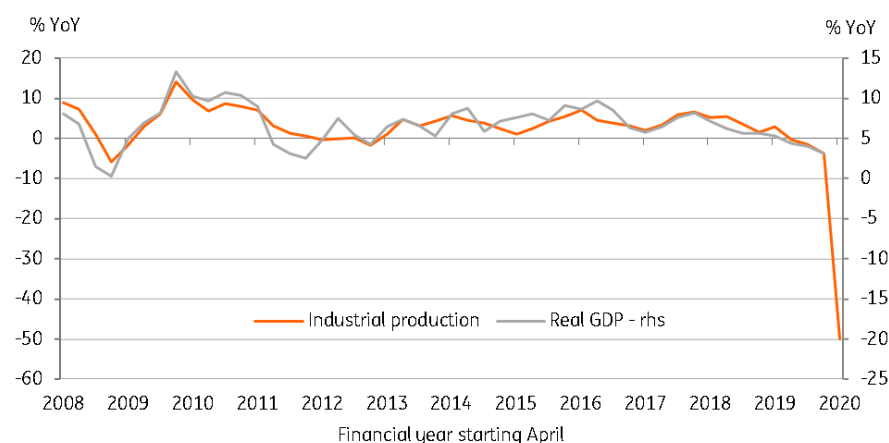
The activity data has been rather scant. The Indian statistics authority recently had to suspend releases of some economic indicators like industrial production and CPI inflation on the grounds of distortion from the lockdowns. However, the authority's quick estimate of a 55% year-on-year fall in industrial production in April, together with a record low manufacturing PMI for May (30.8 in May), and crashing exports (-37% YoY in May after -60% in April) give a hint at the damage. So, too, does an estimate by a local think tank of over 20% unemployment.

The five most Covid-19-affected Indian states (Maharashtra, Delhi, Tamil Nadu, Gujarat and Uttar Pradesh) make up 43% of India's GDP. Recovery here will hinge on the return of a large number of migrant workers, though not all of them are likely to be reabsorbed back into disrupted supply chains, while weak demand continues to hinder activity.

Meanwhile, high unemployment should depress spending and prices, though there are no signs of consumer price inflation abating just yet. On the contrary, resurgent food inflation resulting from supply disruption and panic buying, and high fuel prices due to recent hikes in excise duty, are pressuring inflation, keeping it near the top end of the central bank's 2-6% policy goal.

We cut our GDP view to show a steeper contraction in 2Q20, by -11.7% against -7.6% previously. Absent a vigorous macro policy thrust, continued negative growth remains a baseline for the rest of the fiscal year (ending in March 2021). Our revised growth forecast for the current fiscal year stands at -5.2%, down from -2.1% earlier and making it the worst year for the Indian economy in five decades. There is no change to our inflation forecast for the year from 4.3%.

Where is growth heading?



Source: CEIC, ING

Insufficient policy support

Tight public finances limit the availability of fiscal support. In May, the government unveiled a big-bang in the form of an INR 20 trillion (10% GDP equivalent) stimulus package. However, the real fiscal thrust in this was meagre, about 2.6% of GDP. The rest was fluff, including structural reforms in critical sectors. That's helpful over the longer-term, but doesn't provide much immediate help for the economy. Moreover, whatever little real spending was announced might not even come through given the latest reports of the government looking to rationalise its spending, as

worsening public finances invite the wrath of rating agencies. Moody's and Fitch Ratings have just downgraded the outlook on their Baa3/BBB- sovereign ratings to Negative from Stable. S&P might soon follow suit.

The Reserve Bank of India, the central bank, has been responding to the urgency of the situation though. In addition to liquidity boosting measures, the RBI has cut the policy rate by a total of 115 basis point so far this year, taking the repurchase rate to an all-time low of 4.0% and the reverse repo rate to the lowest since the 2009 global financial crisis, at 3.35%. Even as these moves have pushed real interest rates deeper into negative turf, we think the RBI easing cycle has further to go. We anticipate one more 25bp cut to the main policy rates in the third quarter.

Against such an economic and policy backdrop, the Indian rupee should continue to be one of the worst-performing emerging market currencies throughout the rest of the year. At 75.6 against the US dollar currently, the INR has depreciated 5.6% year-to-date. We continue to see further weakness to 77.4 by end-3Q20.

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