

Good MornING Asia - 31 May 2018

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By Robert Carnell



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Markets recover from latest jitters

It seems odd, but the Italian coalition government markets once most feared, is now deemed preferable to another election



Source: Shutterstock

Better the devil you barely know...

Markets have recovered their poise now that alternatives are being sought for the Italian finance ministry job after President Mattarella blocked the appointment of Eurosceptic, Paolo Savona. 5-Star's Di Maio has sounded willing to nominate a new Finance Minister, but the League's Salvini is holding back. Failure to find a compromise candidate for the Finance Ministry job could well see Italy going to the polls again, and maybe this time, the election would be fought out along the lines of Euro-membership or exit. We expect to see new suggestions for the cabinet rolled out on Tuesday / Wednesday.

But even then, we don't see an imminent referendum in Italy on Italexit. Firstly, both 5-star and the League have toned down their eurosceptic comments and say they do not intend to lead Italy out of the Eurozone. Secondly, failure to endorse constitutional reforms back when Matteo Renzi was leading the country, means that the constitutional road to euro exit is a long and arduous one for Italy and not even one that would necessarily be voted for. It is not even strictly true to state that Italy is one of the most Eurosceptic members of the single currency. With about 60% of the electorate broadly in favour of remaining in the Euro, it could perhaps be described instead as one of the least Europhilic.

Still, having been away from my desk for the last 4 days, it is remarkable to see how markets have

reacted to this turn of news - and scarcely conceivable that this Italian story is entirely to blame for the gyrations in the US Treasury market. Surely there's more?

All is not well on the trade front

Although different members of the US trade negotiating team seem to have different views on how progress with China is going, a more pressing deadline is looming in terms of the deadline for talks between the EU and US on steel and aluminium, which expires tomorrow. The EU has outlined the US goods it will sanction in retaliation for the tariffs. This would push the trade war another step along a path that can only lead to slower global growth, higher prices, and lower profits. That there may be political motivations for the US tariffs we do not dispute. But 3000 years of history strongly demonstrates that more trade makes us better off. We don't think anything has changed in the last few years to change that conclusion.

Inflation dominates G-7 calendar

Following stronger than expected German May inflation data yesterday, that could well translate into a higher figure for the EU as a whole, released later today. The headline numbers are estimated to have picked up from 1.2%YoY in April to 1.6% in May, but the German numbers indicate that a 1.7% or even 1.8% outcome cannot be ruled out. If so, that would put ECB tapering back into the limelight, which given a helpful shove by Italian politics, could see the EUR make back some of its recent lost ground.

PCE inflation in the US is likely to have stayed at 2.0%YoY in April, and the core rate maybe even eased back from 1.9% to 1.8%. But even an upside surprise here is not likely to elicit much response from markets, given the FOMC's recent intimation that it might allow inflation to run a little higher than target until expectations have picked up.

APAC day ahead

The Asia Pacific calendar has got off to a mixed start with the Korean industrial production numbers for April bouncing from -2.2%MoM, to +3.4%MoM, and lifting the year on year rate of growth back into positive territory. The cyclical leading indicator is still looking pretty negative, however, and we aren't completely convinced that this downturn is over. That said, we aren't all that concerned either. This is a good-old-fashioned inventory led production downturn. They come, but they soon go again, and the economy comes back stronger as a result.

Japan also released April industrial production data this morning. The general picture in Japan is similar to that in Korea, with inventories weighing on production. And the 0.3%MoM gain in April was much less than the 1.4% expectation. Electronics were one of the weaker parts of the production story. That said, inventory ratios now seem to be moving in the right direction, and the worst of the inventory correction in Japan may now be over. Better data loom ahead.

India releases 1Q18 GDP later today. We aren't as upbeat as the consensus on this number ([see here for more detail](#)) and are looking for the RBI to hike rates again as soon as next week to provide further support for the rupee. Thai Balance of Payments trade data is also released today, but as we have already had the customs basis figures for April, this should not be much of a market mover, and has little impact on our expectations for [Bank of Thailand Policy](#)).

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Why we're forecasting the yuan to depreciate

Even though concerns about depleting foreign exchange reserves could limit the extent of yuan weakening, a depreciation trend is more likely than before. That's why we're changing our USD/CNY forecast to 6.60 for 2018 from appreciation to depreciation



Source: Shutterstock

Why China will be more willing to take advantage of a stronger dollar

Trade war escalations between China and the US along with rising political risks in Italy and Spain have formed a strong dollar trend, and this is the key reason why we're revising our yuan forecast.

A strong dollar is likely to create headaches for the US administration as this won't help narrow its trade deficit with China. As the greenback strengthens against most major currencies, China should be willing to allow a weaker yuan as it sends a signal to the US that the exchange rate movements are largely a result of a steep dollar rather than any manipulation by China.

In other words, this means China is being passive ending up with a weaker yuan against the dollar. This passive influence by the strong dollar makes us think a slight depreciation of the yuan against the dollar is more likely than we previously believed, even though we thought this was unlikely.

But the central bank won't want capital outflows

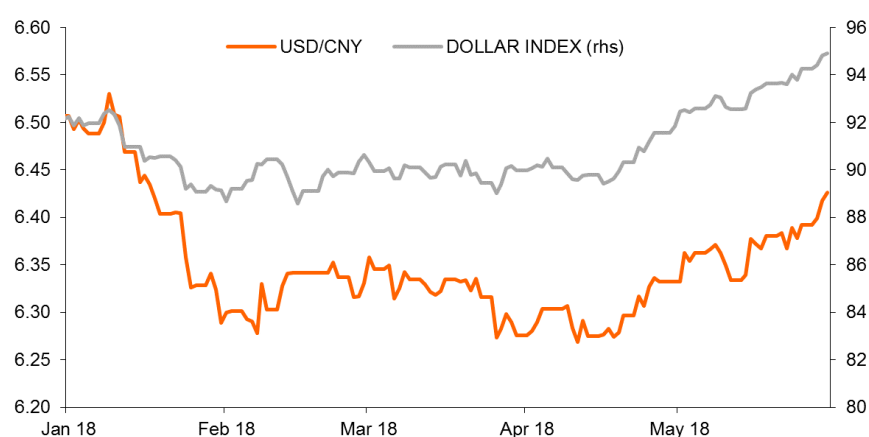
But a steep yuan depreciation is not our call.

The dollar index has strengthened more than 1.7% year to date, and the yuan against the dollar has also appreciated by around 1.2% which implies that the yuan still has some room to weaken, especially if the dollar keeps strengthening.

The contradictory movements of appreciation of both the dollar index and the yuan at the same time show the Chinese central bank is unlikely to allow a longstanding yuan depreciation against the dollar. The People's Bank of China (PBoC) will try to prevent the yuan weakening to a level that attracts massive capital outflows and lead to depletion of foreign exchange reserves. It probably wants to avoid a repeat of mid-2014 and 2016 when reserves fell too quickly.

We think if foreign exchange reserves fall below the \$2.5trillion level, the weakening yuan will start to stabilise to avoid further capital outflows.

Yuan still appreciating against the dollar YTD even though the dollar has been stronger



Source: ING, Bloomberg

Capital inflows are coming but might not be enough to offset outflows

The central bank could get some capital inflows from China's open-up policy in the financial sector and A shares' inclusion into MSCI. These would offset some of the value effects on China's foreign exchange reserves from a strong dollar (i.e. non-dollar asset values come down in dollar terms).

Another way to avoid capital outflows would be to increase interest rates in China to widen the interest rate gap between China and the US. Currently, interest rate spreads have narrowed, which triggers a capital outflow worries.

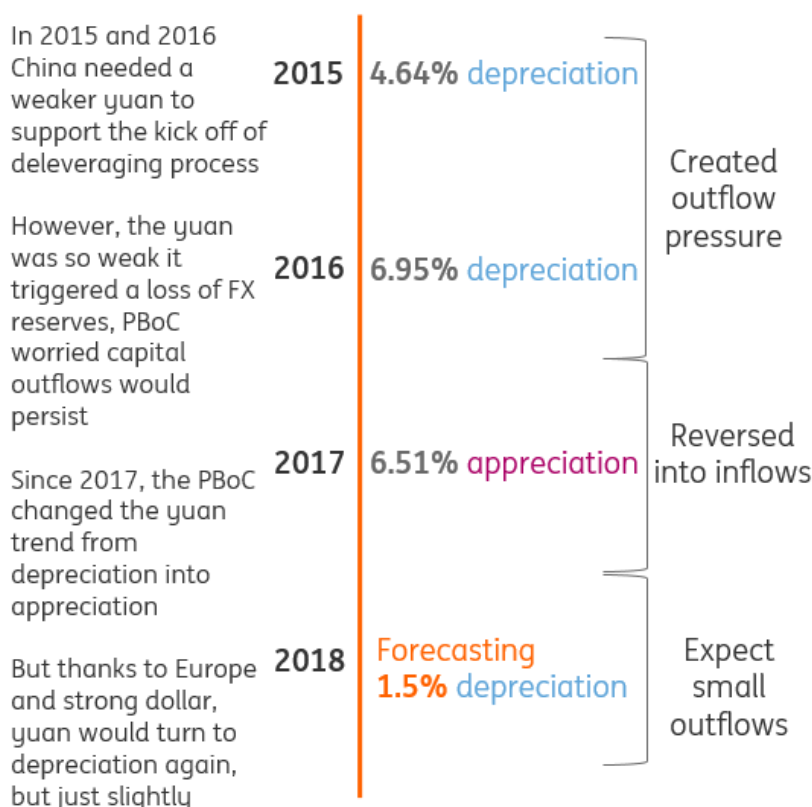
To reverse the recent trend and increase interest rate spread, China needs to tighten liquidity further and/or raise the 7D policy rate by more than five basis points each time when it follows the Fed's hike. However, by doing so, the interest costs will increase in China. The central bank may be hesitant to do this now as there are increasing default risks from local government related credits,

and the timing is nearer to half-year end when liquidity is usually tighter.

In short, creating a wider interest rate spread between China and the US by the Chinese central bank is quite unlikely, at least for now. This makes attracting capital inflows and retaining potential outflows more difficult.

It is also likely that the capital control regulator, SAFE, may start to slow down outflows via administrative measures. This was the main tool used in 2016 and could again be a handy tool now.

Yuan and capital flows are intertwined



Source: ING, Bloomberg

Revising yuan forecast

Considering all these factors, we revise our USD/CNY forecasts to 6.60 from 6.33 for 2018. In other words, we expect 1.5% yuan depreciation against the dollar in 2018.

Between now and the end of 2018, there are chances that the dollar strengthens very quickly, which could originate from escalating risks in Europe and USD/CNY could surpass our year-end forecast.

However, we expect that rapid capital outflows (even with administrative measures in place, similar to the scenario in 2016) would then begin, and could trigger falling foreign exchange reserves to the \$2.5 trillion level. By then the central bank is likely to stabilise the yuan to stop foreign reserves from continuously falling. So the chance of USD/CNY surpassing 6.60 for a prolonged period is quite small.

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China's Xi speaks, Trump reacts

Tensions over a US-China trade war are far from over. On 28 May- before the US announced possible tariffs on Chinese imports and a control list on investments and exports to China- President Xi Jinping made a high-level speech about the need for China to be self-reliant on high-tech products



The timing of President Xi's speech plays an important role in forthcoming trade negotiations

President Xi Jinping's speech on 28 May emphasises building a self-sustained high-tech industry. We think the speech plays an important role in the China-US trade war.

- First, the speech was made by President Xi himself, suggesting the objective of building a self-reliant high-tech economy is concrete with a high chance of success given Xi's power of execution.
- Second, the timing of the speech is significant. It was given before the US administration announced a list of tariffs on Chinese goods (on 15 June) and a list of investment and export controls on high-tech products into China (before 30 June).

US reaction to Xi's speech

President Xi's speech likely hit a nerve in the US administration. We expect the US to try to

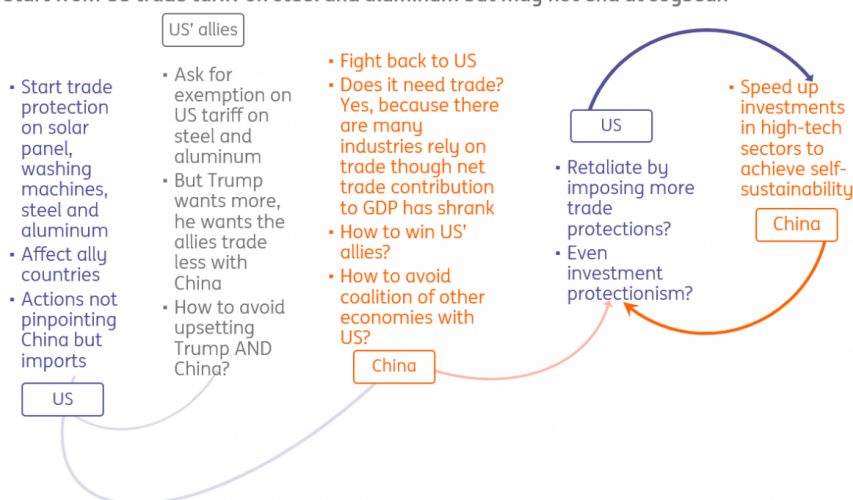
interrupt China's Made in China 2025 plan by imposing controls, especially through investments and exports of high-tech goods and services to China.

Xi would have known that the US would react to his speech. We believe, therefore, that China is prepared to put sizeable investments into the high-tech sector to achieve its target so it doesn't need to depend on US tech products. Still, it's impossible to yield any positive results from these investments before the end of June.

The forthcoming announcements of the two lists by the US administration are crucial to future trade and investments of China and the US. The Trump administration's latest move suggests that its claim of putting the trade war "on hold" after the latest round of negotiations is not binding.

Trade war? Investment war?

Start from US trade tariff on steel and aluminum but may not end at soybean



Source: ING

China could lower tariffs to the rest of the world, as well as to the US

As a buffer to trade tension, China may import more consumer goods by lowering tariffs for the rest of the world, in addition to the US. These may include health-related products, baby products and cosmetics, which are sought after by Chinese tourists when they shop abroad. Though the value of these goods would not change the trade of goods' deficit situation of some economies with China it would at least calm trade tensions.

However, from China's current account point of view, this may not create a big change. The Chinese will likely spend more money at home on domestic imports rather than shopping overseas, so it could be that some imports of services move to imports of goods. Though the pie of imports of consumer goods would become bigger with a growing middle class, this growth would likely be gradual.

We should be aware that it is difficult for China to give in more than this, especially as this is about China-US bilateral trade, which is still under negotiation.

China investment will focus on high-tech R&D and talent pool

This is not the first time that President Xi has emphasised that China needs its own technology to survive in the future. The government is aiming to achieve more self-sustained technology by 2020.

This is an aggressive and challenging target. But it is not impossible because China is on a strong growth path, which makes it easier to spare more investment for a particular objective that the government believes is vital to its future growth. Inevitably, before there is any positive result from these investments, China's debt, particularly government debt, will grow.

President Xi's speech also emphasises that China will achieve its goal by growing its talent pool in the high-tech sector. We expect that talent from around the world will be attracted by this opportunity. However, this is not without challenges. The rest of the world may not be willing to export its talent to China. We believe that another war is coming, a war for talent.

Investment will be the new growth driver

Investment growth driven by the high-tech sector is likely to increase before any change in tariffs slows down Chinese export growth.

But trade tensions will delay business investment decisions and could disrupt the future supply chain of the semiconductor industry, which will partially offset the contribution of investment growth to GDP.

Given that China will invest more in high-tech, the job market should be stable and support current growth in consumption.

The combined effect means that our China GDP forecasts of 6.8% in 2018 still holds, although the forecast has an upside risk from fast and sizeable investments in high-tech sectors.

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India: Weak rupee to push RBI to tighten next week

An accelerated currency depreciation trains the market focus on the Reserve Bank of India's (RBI) forthcoming policy meeting on 6 June. We expect the RBI to tighten with a 25bp policy interest rate hike



Source: Shutterstock

Will the Reserve Bank of India follow its emerging markets counterparts in raising policy interest rates to curb the currency depreciation? We believe it will. We bring forward our forecast timing of the first 25bp policy rate hike to June from August, taking the repo rate to 6.25% and reverse repo rate to 6.00%. However, absent any policy support next week another downgrade of our USD/INR forecast, currently, 68.3 for end-2018, will become inevitable (spot 67.5).

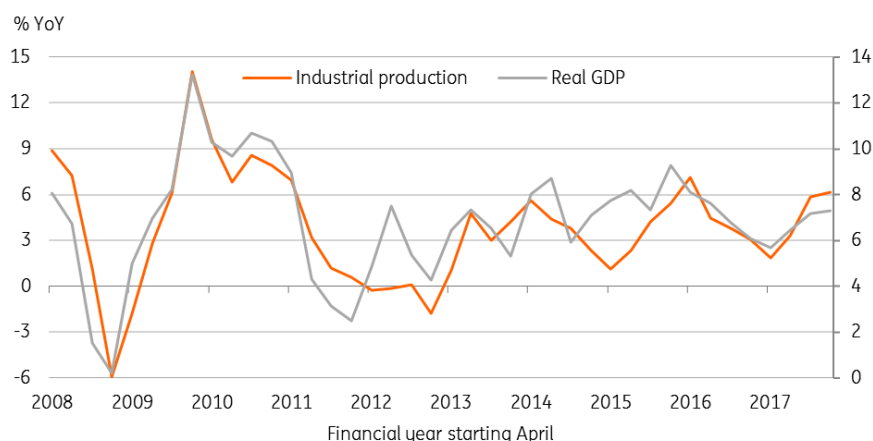
Room for downside growth surprise in 4Q FY18

India's GDP data for the final quarter of FY2018 (ended in March 2018) is due on Thursday 31 May. The consensus is looking for a modest pick-up in growth to 7.4% year-on-year from 7.2% in the previous quarter. Our forecast is 7.3% growth.

Hopes are pinned on the low base effect supporting upward growth momentum. However, the

monthly activity indicators suggest no improvement in 4Q FY18 from the 7.2% pace recorded in the previous quarter. Slower exports and a wider trade deficit were the main negatives for GDP growth, while higher inflation likely weighed down consumer spending. On the positive side, manufacturing gained some momentum as reflected by better industrial production growth, supporting the consensus of a better GDP outcome (see below).

A close correlation in India's GDP and IP growth



Source: CEIC, ING

Little in GDP data to curb INR depreciation pressure

GDP data is unlikely to resuscitate investor confidence in the Indian rupee (INR), in our view. The 6% year-to-date INR depreciation against the US dollar is the steepest among Asian currencies this year. The accelerated depreciation in the current emerging market turmoil poses the question: will the Indian central bank follow its emerging markets counterparts in Turkey, Indonesia, or the Philippines in raising policy interest rates to curb the currency depreciation?

This trains the market focus on the forthcoming RBI policy meeting next week (6 June). Unlike Turkish or Indonesian central banks, the RBI has no history of thrashing policy measures. There is a significant minority in the Bloomberg survey, only three out of 14 forecasters as of this writing, looking for a 25bp rate hike next week. And the consensus within the six-member RBI monetary policy committee (MPC) until the last policy meeting in April had been biased towards a continued neutral stance, though we can anticipate some shift towards tightening in the coming week.

6%

Year-to-date INR depreciation against USD

The most among Asian currencies

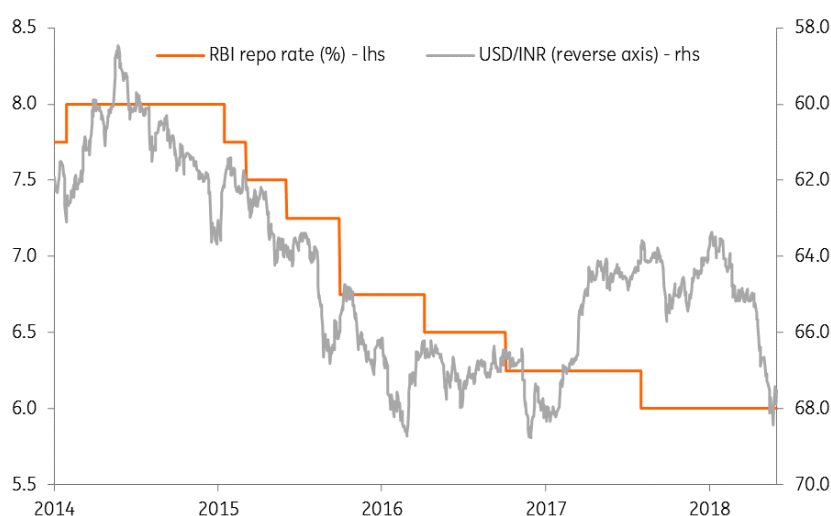
Expect RBI policy tightening as early as next week

It's going to be a tricky call though. Up until the last RBI meeting in April, there was only one dissenting vote supporting a rate hike. But at the same meeting the deputy governor in charge of monetary policy, Dr. Viral Acharya signalled his decisive vote for tightening in June. The rest of the MPC members are well aware of potential inflation risks due to several external and domestic

factors. Now with a further intensification of inflation risk due to a weak currency, we believe the odds have increased for a majority vote in favour of a rate hike next week.

We bring forward our forecast timing of the first 25bp RBI policy rate hike to next week's meeting from the August meeting, taking the key policy rates, the repo rate and the reverse repo rate to 6.25% and 6.00% respectively. We also expect a further pre-emptive tightening by 25bp at the August meeting. However, without any policy support next week another downgrade of our USD/INR forecast, currently 68.3 for end-2018 (which we revised from 66.6 a month ago), will become inevitable (spot 67.5).

INR needs policy support



Source: Bloomberg, ING

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Thailand's central bank signals steady policy

We continue to forecast no change to the Bank of Thailand monetary policy this year. We see the current global market turmoil pushing USD/THB to 32.50 in the near-term



Source: Shutterstock

The central bank policy minutes back up our long-held view that there will be no change to monetary policy this year. We expect the current global markets stress to push the Thai baht (THB) exchange rate versus the US dollar, currently 32.14, to 32.50 in the near-term.

The Bank of Thailand minutes

The minutes of the Bank of Thailand monetary policy meeting held on 16 May revealed the central bank's preference for continued policy accommodation. The key highlights of the minutes are:

- **Growth:** the Committee viewed that growth developments still warranted monitoring for some period. Accommodative monetary policy thus remained necessary to support more broad-based and strong domestic demand.
- **Inflation:** upward pressure on inflation in the period ahead might be lower than in the past, as wage increases are having only limited effects on inflation, oil price increases are partly

compensated by subsidies, and increases in agricultural prices are less likely due to an expansion in the agriculture land base worldwide.

- **Household debt:** Thailand's elevated household debt has declined at a slower pace, partly reflecting some structural problems that have yet to be fully resolved.
- **Currency:** Looking ahead, the baht will likely experience volatile movements mainly due to uncertainties pertaining to the conduct of monetary and fiscal policies in advance economies as well as geopolitical risks and oil prices.

The minutes concluded, "The Committee concurred on the need to maintain accommodative monetary policy stance and would stand ready to utilize available policy tools to support the continuation of economic growth while preserving financial stability".

Downside growth risks

Also released today, Thailand's manufacturing growth accelerated less than expected to 4.0% year-on-year in April from 2.6% in the previous month. Our forecast was 4.1% against the consensus of 4.3% growth. A pick-up in manufacturing growth squares with a pick-up in export growth over the same months. However, this was all about the low base effect boosting year-on-year growth, rather than an underlying improvement. April is typically the weakest activity month in the year due to the Songkran (Thai New Year) holiday. A sharp drop in manufacturing capacity utilisation to 61.6% in April from 76.3% in March bears this out.

Data signals a good start to the second quarter given that manufacturing drives GDP growth. At 4.8% YoY in the first quarter of 2018 GDP growth was the fastest in five years. However, sustaining such a performance in the rest of the year will be a challenge amid uncertain financial market conditions, rising oil prices, and an unfavourable base effect for GDP growth. As such, our 4% growth forecast for this year is exposed to downside risk. So is the central bank's 4.1% growth forecast.

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