

Good Morning Asia - 4 June 2019

The St Louis Fed President, James Bullard, thinks rate cuts may not be so far off (FOMC voter this year), the market, which loves this idea, has moved further in this direction - ISM data also softer

In this bundle



Bullard not so bullish

The St Louis Fed President, James Bullard, thinks rate cuts may not be so far off (FOMC voter this year), the market, which loves this idea, has moved...

By Robert Carnell



Asia Morning Bites

ASEAN Morning Bytes

General market tone: Wait and watch. Asian markets may steady on bargain hunting as investors hope for the Fed policy easing.

By Nicholas Mapa



FX | China

China: Revising yuan lower but 7.0 should hold

We are revising our USD/CNY and USD/CNH forecasts to reflect expectations for a weaker yuan. This is a result of the rising tensions between China and the...



Malaysia

Malaysia: A pleasant surprise from April trade data

Our view of the USD/MYR exchange rate hovering around the 4.2 level for the rest of the year remains at risk from the havoc that an escalation of the...

Opinion | 4 June 2019

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2.07%

Yield on 10Y US Treasury

Still falling

Down, down, deeper and down

Saying that the Fed may need to cut rates soon to prop up inflation and inflation expectations, as St Louis Fed President, James Bullard did yesterday, has provided US bond markets with the nudge to keep going in the direction that they seem perfectly happy to keep following. 10Y US Treasury yields hit 2.07%. Can they go further?

The answer is obviously, yes. But at these levels we should begin to ask ourselves at what point we want to jump off this runaway train? The equity market is clearly a very key factor in the direction of Treasuries currently. Last night, it was the tech stocks that took a hammering on antitrust investigation reports. Macro also helped though. The manufacturing ISM also fell, though importantly not the employment component, which rose strongly to 53.7 - perhaps a snippet of good news just days before Friday's jobs report and a reminder not to get too carried away.

Just like many other writers in this field, I am struggling to reconcile the macroeconomic backdrop

with the market Fed view. Of course, the latest Mexican tariffs and China's more aggressive retaliation amplify the trade war downside risks. And yes, I can see that this will weigh on stocks. But how far would you need to see the stock market decline before it merited a countervailing rate cut? I don't think there is a ready reckoner for this (email me if you have one). But quite a long way I would think. So does this mean that Bullard thinks the equity market is about to tank? Well if the S&P500 falls below 2720, it will probably make it down as far as 2650. Under those circumstances, I think yields could break 2.0%, and then, maybe yes, I will find it less of a stretch to consider some Fed easing. Though we would still be a long way North of last year's correction. We aren't there yet though.

Impact on the USD

We wrote yesterday that we might be reaching a turning point for the USD. Bullard's comments make that seem a bit of an understatement. But it does indeed look as if at these yields, and expectations for the Fed, the USD is no longer a one-way bet.

I have also been thinking more about the possibility that greater retaliation against the US in the trade war. We also wrote yesterday about China's Trade White paper, "unreliable entities" and threats to rare earth exports. This morning I read about Mexico's threats of retaliation. This is news because so far, the trade war has been pretty one-sided. The US has slapped tariffs on a great many countries, and the retaliation has been minimal. That is a dollar-positive backdrop. But as patience reaches its limits, and hopes for trade deals give way to pessimism, and retaliation surges, then this becomes much more of a two-way street for the USD. There is certainly scope for the USD to depreciate as countries decide that they aren't simply going to sit back and take it anymore. Could this mark the bottom? For that, I think some change in tack by the US on trade will be needed. But I don't think we can just expect to automatically revert back to the previous USD strengthening trend now.

RBA - cutting

We wrote about the RBA yesterday - [here is the link to our longer piece again too](#). There's little new to add. PMI data yesterday were a little softer, and inflation expectations also fell a bit. Retail sales figures this morning might add a little to the gloom. The consensus is for the month-on-month growth rate to slow to 0.2% from 0.3%.

Markets will be focussed on the forward guidance from this rate decision, which is unlikely to be an isolated cut. How much and how soon can we expect rates to fall? We may know a little more later today. The US/Fed story obviously is not totally isolated from future RBA decisions on rates either.

Korean 1Q19 GDP revised down to -0.4%

I don't want to point any fingers following the Bank of Korea's decision not to cut rates at its meeting last week, but since then, the data out of Korea has been rotten. Continued sharp falls in exports, big falls in the manufacturing PMI, and today, a revision to the 1Q19 GDP print, which takes it down to -0.4% (previously -0.3%) and smaller than anticipated rise in inflation, which remains a meager 0.7%YoY.

I've bored you all enough with the reasons the Korean economy would have benefited from a rate cut last month. It may be too much to hope for a change of view before the July meeting, but I don't expect the dataflow to stop pushing in this direction.

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EM Space: Disappointing US manufacturing data sparks calls for Fed cut

- **General Asia:** Poor manufacturing data out from the US coupled with a dovish Fed official pushed some speculation that the Fed could cut rates sooner. Oil markets dipped in reaction to global growth fears, but supportive comments from Saudi Arabia kept oil from falling further.
- **Malaysia:** Painting a mixed picture of GDP growth in the current quarter, the trade growth returned to positive territory in April (read more here) but manufacturing slump deepened in May. Absent underlying drivers, our forecast of a slight pick-up in GDP growth in 2Q19 (to 4.6% from 4.5% in 1Q) relies on a favourable base effect. We forecast no more BNM policy easing this year.
- **Thailand:** Released this morning, manufacturing PMI fell to 50.7 in May from 51.0 in April. Although still in positive territory, a contrast with most Asian countries reporting sub-50 reading, we expect weak manufacturing continue to weighing down GDP growth in the current quarter. And with the inflation on a receding trend, the BoT has more room to ease the policy to support growth. Look out for CPI data for May later today.
- **Philippines:** The Philippine Senate approved a tax on so-called sin products, levying higher taxes on tobacco and electronic cigarette products. The new measure is seen to bring PHP

31bn in fresh revenue for the government and will be used to partially fund the President's hallmark universal healthcare bill.

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

- 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: Revising yuan lower but 7.0 should hold

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Source: Shutterstock

Our yuan forecast has been hit by the technology war

Back in April, we thought trade negotiations were progressing well. We were wrong. China has since demanded a revision to the terms of the draft trade deal which it says are "disrespectful" to China. This move has rocked the market globally.

USD/CNY jumped from 6.7349 at the end of April to 6.7915 at the open of the first trading day in May. This change of sentiment means the yuan is going to depreciate rather than appreciate for the rest of the year.

China also wants to leverage the yuan's depreciation, showing that it does not intend to appease the Trump administration, which has urged Beijing to stabilise the value of the yuan.

Letting the USD/CNY or USD/CNH pass 7.0 is playing with fire

While we do expect the yuan to depreciate, we need to answer the big question of whether the USD/CNY or USD/CNH will pass the key 7.0 mark.

We believe that the yuan exchange rate will not be allowed to touch this level as this would create considerable turmoil in onshore asset markets. We believe that the central bank will prevent this from happening.

If the People's Bank of China were to let the USD/CNY pass 7.0 tomorrow, this would result in a depreciation of 1.33% in a single day. Exporters wouldn't receive more orders simply because their product unit price is 1.33% cheaper, so this move wouldn't make a significant impact on exports.

However, letting the USD/CNY pass through 7.0 has the potential to lead to considerable volatility in the onshore equity market, similar to what followed the sudden exchange rate liberalisation event in 2015. Since the collapse in 2015, the A-share index has not returned to its high of 5,353 points and closed at 3,632 points on 3 June 2019.

As the trade and technology war escalates, Chinese policy makers are likely to aim to dampen uncertainty to the market. As such, we rule out any scenario of USD/CNY and USD/CNH passing through 7.0 unless tensions ease to a level where there is no longer any threat of a trade or technology war, something we do not expect in 2019.

Revising yuan forecasts

We are revising our USD/CNY and USD/CNH forecasts to 6.90, 6.95 and 6.90 by end of 2Q, 3Q and 4Q 2019, respectively, from our previous forecast of 6.75 by the end of 2019.

We expect the central bank, PBoC, to stabilise the onshore yuan mainly through stabilising the daily fixing of the exchange rate, so as to send a signal to both onshore and offshore markets that the yuan is stable.

The spread between the onshore and offshore yuan, which is the difference between USD/CNY and USD/CNH, should not increase, as there are very few arbitrage channels for carry.

The spread between onshore and offshore yuan not large enough for cross border arbitrage



Source: ING, Bloomberg

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Source: shutterstock

1.1%

Export growth in April

Year-on-year

Better than expected

Trade growth turns positive

Contrary to expectations of a continued contraction, trade growth turned positive in April.

Reported in local currency (Malaysian ringgit, or MYR) terms, exports grew by 1.1% year-on-year in April after two consecutive months of declines in February and March. The consensus was centred on a 2.1% fall. Electronics and oil-related exports were the sources of firmer headline export growth. By destination, shipments to the US stood out positively.

Outpacing exports, imports grew by 4.4% YoY in April, which in turn resulted in a narrower trade surplus of MYR 10.9 billion from March's MYR 14.4 billion.

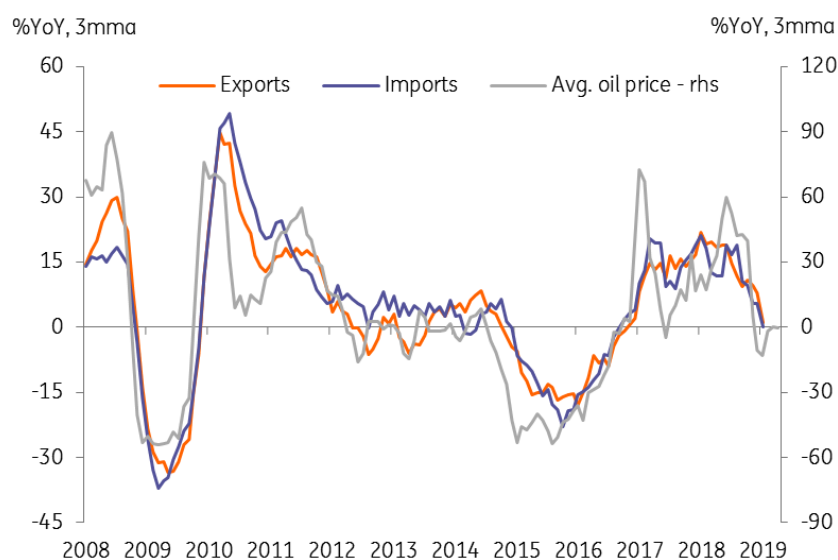
Still widening trade surplus

Cumulative exports and imports in the first four months of the year are nearly flat at their respective levels last year. Yet, the trade surplus is widening – at MYR 47.8bn it was 1.4bn higher than a year ago. Surprisingly, electronics exports are holding up well in the face of a downturn in global tech demand and this is helping exports and hence the trade surplus.

We also surmise some domestic demand weakness now kicking in, as the fiscal policy support that the economy enjoyed in the last year starts to fade, weighing down imports. Despite this, we don't expect 2019 to be yet another year of large trade surpluses like the MYR 120 billion surplus recorded for 2018, which was an MYR 22 billion increase over 2017.

Weak global demand and subdued commodity prices are likely to depress trade growth this year.

Commodity-driven trade growth



Source: Bloomberg, CEIC, ING

Under US Treasury's radar for currency manipulation

A steady trade surplus means a steady current account surplus. High current account surpluses, in excess of 2% GDP, and a large bilateral trade surplus with the US pushed Malaysia into the US Treasury's monitoring list of countries suspected of manipulating their currencies for export advantage. Malaysia dodged the bullet on the third criterion of persistent one-sided currency market intervention.

The ringgit exchange rate is market-determined and is not relied upon for export competitiveness. – Bank Negara Malaysia

This is the first time Malaysia has appeared on the US Treasury's radar. We don't see any imminent threat of outright labelling of Malaysia as a currency manipulator which could lead to sanctions. Moreover, Malaysia's economic history of the last two decades reinforces the government's preference for a stable to stronger ringgit.

That said, our view of the USD/MYR exchange rate hovering around 4.2 level in the rest of the year remains at risk from the havoc that the escalation of the global trade war wreaks on emerging market currencies.

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