

Good Morning Asia - 4 October 2018

What do yield curve pessimists talk about now that the 2s10s slope has steepened? And what's in store from India's central bank policy meeting on Friday?

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By Robert Carnell



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Bond yields: Not so flat now

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Source: Bloomberg

Does a higher bond yield signal better, or worse times ahead...better surely?

US 10Y Treasuries have risen - really sharply, from the low 3's recorded earlier this week, and are now at about 3.18%, after the largest single-day upswing since November 2016, according to Bloomberg.

To be honest, the US data was pretty good! The private ADP survey of employment was very strong at 230K, and in my personal opinion, is better jobs data than Friday's official labour market report. The non-Manufacturing ISM index, at 61.6, reached its highest apparently (same source) since August 1997, with a massive leap in the employment index. To put it in perspective, this was just 3 months into the UK's Blair government - I had just started work in the private sector after 4 years with the UK government. My hair still had colour and I was about 30kg lighter (but was I happy?). This ISM release is a relatively small survey, and spikes this high don't usually last. Indeed, they often seem to mark a peak for the economy, with sometimes rapid deceleration within a year or so.

But I can't deny the data were good, very good. And if this is reflected in Friday's labour report (especially on wages - the market is bored of jobs gains), albeit, with a healthy dose of adjustment for the impact of the recent Hurricane's ([see also James Knightley's report on this](#)), yields at this level could stick around or conceivably go higher. We are already within 2bp of our house-call for end of year yields at 3.20%, and not far from our 1Q19 peak call of 3.30%. Maybe there is a little upside to even these numbers. Our new October forecasts will be released shortly.

Fed speakers don't give yields cause for a turnaround

Although a handful of Fed speakers in a single day is enough to have you thinking of the towers of Babel, the overall message of cautious tightening continuing seems loud and clear. There was one slightly worrying note from Chairman Jerome Powell, which, with reference to the neutral rate of interest, said that although the Fed may go past neutral in hiking, "we're a long way" from that. If this was meant as a comforting comment, it only suggests that rates have a lot further to rise. I don't think this is what he meant to imply.

Cause for happiness, or concern?

So with US yields rising on a tide of good news, should we be happy or worried? Well, that depends where you live. Here in Asia, the US story is a double-edged sword. Normally, one side of that sword would be the implied gains in Asian exports to the US and the rest of the G-7 based on soaring domestic demand there. But that edge has been thoroughly blunted by US trade policies. The other side, higher global interest rates, and a stronger USD are certainly not helpful. Today, Asian FX appears to be struggling to hold a line, with even robust units like the SGD and THB feeling the pressure, and of course, the more fragile IDR, INR and PHP are under greater pressure.

Eyes on the RBI

With the calendar in Asia still pretty bare today, most of the conversation is looking towards tomorrow's RBI rate policy meeting, which Prakash Sakpal has written about in a [new note](#).

While a 25bp hike is looking almost a given (if they don't the INR will get crushed), there are concerns over liquidity within the financial system, and additional measures may also be needed to provide the INR with support even with a 25bp rate hike. Prakash has moved up his end of year USDINR forecast to 75.0 as we are already knocking on the door of his earlier 73.5 forecast.

Could a 50bp hike be envisaged? Basically, we wouldn't rule it out, though it would be out of character for the RBI, with another 25bp hike in December our base case. Even then, without additional supporting measures, we would imagine INR support from this unexpected move might prove short-lived.

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International theme: ADP and ISM numbers in-line with strong US growth story

- US economic data continues to print on the upside with numbers on jobs and the services industry support the Fed's tightening bias. Markets will continue to monitor trade developments and oil prices for further direction.

EM Space: Good US data spells some pressure for EM Asia

- **General Asia:** Asian markets will likely continue to move sideways albeit with a downward bias after US Treasury yields climbed on robust economic data out from the United States. Trade concerns and sustained elevated levels for oil prices will also likely weigh on sentiment.
- **Thailand:** The Bank of Thailand minutes revealed that the MPC focused on the timing to begin policy normalization, which it said was data-dependent. However, MPC continued to assess the current accommodative policy stance appropriate for the economy. The BoT maintained growth forecasts at 4.4% for 2018 and 4.2% forecast for 2019, and inflation forecast at 1.1% for both years, with the balance of risks tilted on the downside for both

forecasts. We are re-considering a view of the BoT starting the policy normalization by mid-2019.

- **Indonesia:** Bank of Indonesia (BI) kept up its use of rhetoric to help stabilize the floundering currency with Governor Warjiyo indicating that although pressures on the IDR persist, he sees the IDR recovering next year as measures to provide support for the currency gain ground. He also sounded off on possible rate hikes in the near term as he vowed to stay “ahead of the curve”, hinting at possible rate action at its next meeting should IDR remain above the 15,000 level.
- **Philippines:** The much-anticipated stock issuance of San Miguel Food is “on-track” and is scheduled for November according to the CEO of the company. The planned issuance will likely attract foreign players and help bring in anywhere from \$1 to 1.5 billion inflows into the Philippines. This issuance together with the planned ROP issuance by the government could help alleviate pressure on the Peso and help it close at 53 by year-end.
- **Philippines:** The NFA has received the go signal to begin bidding out 3 contracts for 250,000 MT worth of rice after hurdling some administrative paperwork. Importations can begin as early as 18 October with imports seen to arrive as early as end-November which could help alleviate inflation pressure on the food basket. Furthermore, the initial batch of rice worth 250,000 MT arrived last 27 September, pushing up rice stocks to 5,000,000 and possibly helping lower October domestic inflation.

What to look out for: US NFP

- Argentina-IMF credit line request (on-going)
- Philippine inflation (5 October)
- Central bank meeting India (5 October)
- US non-farm payrolls (5 October)

India: Never underestimate central banks

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Source: Shutterstock

A confounding consensus on RBI policy

The [recent media headline about the Reserve Bank of India](#) possibly abandoning the rupee was eye-catching but was based on the increased stress in India's financial system due to a beleaguered non-bank finance company going bust and the resulting tighter liquidity conditions.

The fact that higher interest rates will compound the liquidity problem was a setback for the consensus view on the RBI policy. Until the troubles surfaced to batter local markets around two weeks ago, the consensus was biased towards a 25 basis point hike at the next meeting. However, since then, things have become pretty indecisive with almost half of the analysts expecting a 25bp hike and the remaining expecting no hike at all.

We have been in the rate hike camp all along.

6.75% ING forecast
RBI repurchase rate

Will the RBI overlook the weak rupee?

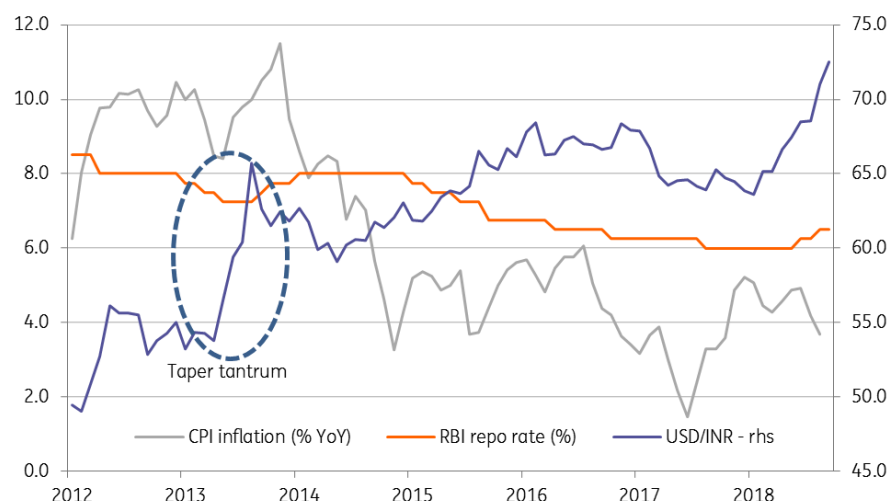
The usual central bank response to a weak currency is aggressive policy tightening, like Indonesia and the Philippines, who have had 150 bp rate hikes recently. But the odds of the RBI following their footsteps seems to be constrained by the central bank's 4% (+/- 2%) inflation mandate, a potential slowdown in growth due to the ongoing trade war, and troubles in the financial system.

We won't be surprised if the central bank hikes more than 25bp, though for now, our base case remains only a 25bp hike and another move in December

The latest rupee sell-off is a mirror image of the sell-off in 2013 and the RBI's response back then was just as lacklustre as it is today. Despite domestic inflation running in double-digits in 2013, they only lifted the policy rate twice by 25bp in September and October 2013.

If history is any guide, then the RBI upping its ante on tightening measures may be a remote possibility, just as the consensus view for the upcoming policy meeting stands.

A lacklustre response to currency turmoils



Source: Bloomberg, CEIC, ING

As other support measures have been failing

Other currency support measures, including import tariffs, relaxation of foreign borrowing limits for

manufacturing companies, removal of withholdings on masala bonds have all failed to do much.

The RBI has allowed commercial banks to dig into their statutory reserves to ease the liquidity crunch. There have been some traces of the central bank intervening in the foreign exchange market to support the currency, but not a lot. The \$22.6bn fall in the country's foreign reserves since the onset of currency market turmoil in April represents the largest capital flight from any Asian economy.

Even as the government has moved to bail the troubled infrastructure finance company out, the uncertainty surrounding restructuring of the company continues to be an overhang on financial markets.

Never underestimate central banks

However, we also find it hard to believe that the central bank will turn a blind eye to the currency problem. Although inflation has been anchored within the RBI's target, it certainly is more of a transitory phase, especially when global oil price are rising and the hit from this on the country's current account deficit is already being compounded by depreciating the currency.

The USD/INR rate has almost hit our 73.50 end-year forecast, which is why we now revise our forecast upward to 75.0 (spot 73.3)

Any central bank in the world will want to be pre-emptive rather than reactive to future inflation expectations and in India's case expectations remain elevated.

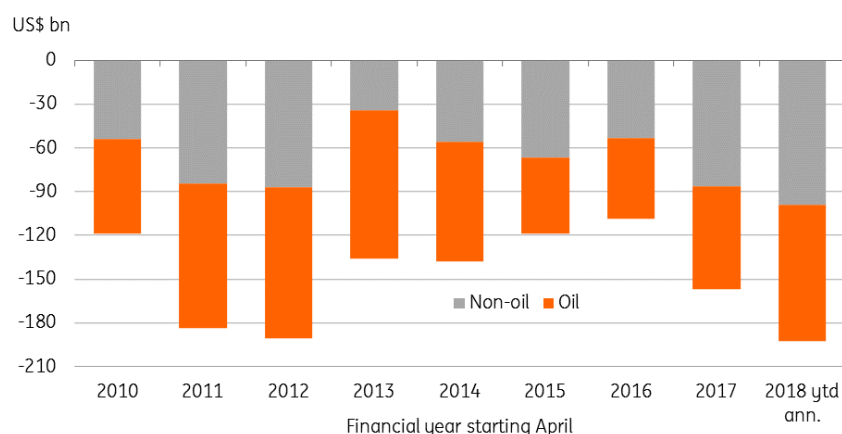
Never underestimate central banks, when it comes to preventing a crisis from eroding investor confidence in the economy and the currency. Indeed the currency and the financial sector troubles will top the agenda for the RBI policy committee this week and an extra policy thrust can't be completely ruled out. This is why we won't be surprised if the RBI does hike more than 25bp this Friday, though our baseline remains only a 25bp now and another like move in the next meeting in December.

Another downgrade of INR forecast

Whether the aggressive policy move (if we get one at all) will eventually keep the rupee from losing further ground remains a perennial question given the lingering risks of a wider trade deficit from high oil imports and elevated inflation expectations. Add to this the political risks becoming a more prominent sentiment driver for markets going into the election year and any additional policy thrust may still prove to be inadequate in an environment of a strong US dollar.

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Oil is swelling the trade deficit



Source: Bloomberg, CEIC, ING

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