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By Robert Carnell



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Crunch time for trade

Optimism is rising about the possibility of some rollback of US tariffs on China in a possible upcoming phase 1 deal.



Source: Shutterstock

I want to believe...

Stories in the press overnight suggest that the US may be considering rolling back some of the tariffs already imposed on China, not just withdrawing, or delaying the implementation of further tariffs.

In particular, this may include the \$112bn of so-called "4a" goods tariffs implemented on September 1. News stories also suggest that existing tariff rates may be reduced.

It seems that China is demanding a high price for its cooperation in any deal, and the US is at least considering delivering.

The effect that this is having on markets is widespread. USDCNY pushed briefly below 7.0 overnight, though it is trading a little higher than that right now. Other "beaten up" Asian currencies such as the INR and KRW have also been gaining on trade enthusiasm. In contrast, safe-haven JPY is looking decidedly soft. Outside FX markets, bond yields are still rising, and at 1.86%, 10Y US Treasury yields are up 0.4pp from their August low point. In commodity markets, safe-haven gold (like the JPY) is weaker, but pro-cyclical commodities such as copper and oil are all stronger. Equities remain in touch with their all-time highs.

If the hype is right, then all these markets have further to go in the event that a deal like the one being talked about actually does get signed.

But...

Our current house forecasts are, in fairness, probably aligned with a more modest phase one trade deal scenario than the sort being talked about today. So if the newswires are right, and a broader phase one deal is delivered, including possibly some sort of "roadmap" to an even broader deal in the future, then we have a fair bit of re-thinking to do. This could include all our FX forecasts, not just in Asia but elsewhere, US Treasury yields, global macro indicators and our central bank forecasts, including the US Fed

But in my view, at least as far as markets are concerned, a lot of upside has clearly already been priced in. We only have to look back a few weeks to see how far we have come.

Moreover, such a deal is not in the bag yet. Critics of President Trump could suggest that he is going soft on China, which may not play well at an important time in the political calendar. It is not a given that the US will indeed play ball and deliver what China is demanding.

What you should probably be doing at this stage if you are neutral to markets' recent moves, is to consider a probability-weighted outcome. So even if you believe that there is a greater likelihood of a successful outcome being reached imminently, the skew in terms of market returns may still make it more appropriate to position for a disappointment. Only you can do the math on this. But, for example, if you think there is a 60% chance of such a deal being struck with further 10% market upside, and 40% chance of disappointment with 25% market downside, then you might still want to consider hedging the downside. You also need to consider how correlated markets are right now to see if you are netting out, or amplifying your risks.

Hail all things "mini"

Nevertheless, there is a lot to be said for a mini-deal. Especially one that lined up the US and China for a more comprehensive deal later.

Indeed when I think about it, many "mini" things are better than the "real" thing. Miniature golf for example - considerably better than the real thing (you need windmills), mini arctic rolls (the big ones are too overfacing), miniature pork-pies (one bite and they're gone, delicious!).

The best corporate entertainment I ever went to in the mid-90s was hosted by the British Merchant Bank, Flemings. I was not with ING back then, but working on the buy-side. It was a gala night for the opening of one of the new James Bond films (I forget exactly which, but I think it was the first Brosnan). In particular, the catering was amazing, because besides the martinis (shaken not stirred) they served miniature fish and chips, in miniature newspaper cones, and miniature cheeseburgers. Heavenly.

But I digress...

Asia today - Bank of Thailand tops the bill

(From Prakash Sakpal): It's "decision-day" at the Bank of Thailand. The consensus has finally come around to our view of one more 25bp policy rate cut to 1.25% this year. Inflation continued its drift toward zero rates in October. And there are no signs of recovery in GDP growth from a five-year

low of 2.3% reached in 2Q19. Further threatening the recovery is rapid currency appreciation. A rate cut won't be a sure-fix for all these woes, but it will be a policy move in the right direction.

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China lowers rate by 5 basis points

China lowers interest rates on the 1Y Medium Lending Facility by 5 basis points. This should put downward pressure on the loan prime rate (LPR) to be announced every 20th.



Source: Shutterstock

PBoC finally lowers interest rates

The People's Bank of China (PBoC), China's central bank, cut 5 basis points off the 1-year Medium Lending Facility (MLF) as expected, bringing the pause in monetary policy from September to an end.

This is a return to the slow rate cut trend that existed before the September pause. 3M repo rates have increased from a range of 2.55%-2.9% in 1Q19 to around 2.80% to 3.3% since September.

The main lending rate will face downward pressure

The main lending rate, which is now the Loan Prime Rate (LPR), should face downward pressure on 20th November. According to the PBoC, the Loan Prime Rate should reference market rates, including the MLF, and consider adjustments on the 20th of every month.

As such, we expect the LPR to fall by 5 basis points for 1-year loans from 4.20% to 4.15%.

For 5-year rates, they have stayed at 4.85% since the start of the formation of the LPR. It seems to

us that the central bank would like to avoid the curve flattening, but as liquidity has tightened since September's pause, it is also possible that the central bank will cut the 5-year LPR from 4.85% to 4.80%.

RRR cut is a question mark for PBoC

As liquidity has tightened, there is also pressure on the PBoC to also cut the reserve rate requirement (RRR) in November or December. But we also think that the central bank might be reluctant to do this as it would like to avoid excessive liquidity. In the absence of strong loan demand, this might be used for asset speculation. And that could lead to a repeat of 2009 when the result was a speculative surge in property prices.

Consequently, we expect that the PBoC will adopt a wait-and-see approach to see if the cut in the LPR will transmit to lower interbank rates. If the transmission mechanism is smooth then the PBoC may save RRR cuts for another time.

Looking forward

We expect the slow rate cut trend to continue into 2020 but with slower momentum, as we expect some progress to be made in the trade talks. At the same time, we expect the trade war will still persist, with no complete trade agreement.

The Chinese economy will face higher interest costs as risk premiums increase with slower economic growth. Rate cuts are a quick solution to lower interest costs, but the central bank could also use the daily open market operations (OMO) to inject short-term liquidity into the financial system and achieve the same result.

We see that the central bank prefers OMO to frequent interest rate cuts and RRR cuts as these policies are longer-term in nature, and may bring China's interest rate to a very low level, which the PBoC wants to avoid.

To conclude, we expect one more rate cut of 5bps and two more RRR cuts (each of 0.5 percentage points) in 2020. The lower interest rate in China has little to do with the exchange rate as the capital account is still semi-closed. Arbitraging activities are to move the yuan softer against the dollar are thin.

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Indonesia: 3Q GDP growth at 5.02%

Indonesia's 3Q growth managed to match market expectations with a 5.02% print amidst global headwinds.



Source: Stenly Lam

5.02%

 3Q GDP

As expected

3Q19 GDP growth matches market consensus

3Q19 growth in Southeast Asia's largest economy hit 5.02% YoY, virtually matching the market consensus for a 5.00% print and almost flat from the 2Q19 growth rate of 5.05%. Year-to-date growth likely settled at 5.05% with the government hopeful for a slight pickup in growth to close out the year, judging by Finance Minister Indrawati's expectation for growth to average 5.08% for the full year. At the start of the year, government officials had forecast growth to hit 5.3%. However, headwinds emanating from the ongoing US-China trade war have forced the government to chase a lower 5.1% target for 2019.

Household spending holds the fort

With global headwinds picking up, Indonesia looked to the domestic economy to hold the fort with household spending up 5.01% in 3Q19 while government spending managed only a 0.98% expansion. Fixed capital formation continued to grow, but showed only a 4.21% expansion with the trade sector clearly the biggest drag on the economy. Net exports were largely flat, reflecting the weak export environment. In the coming quarters, the government hopes to provide a twin dose of stimulus. Indrawati has pledged fiscal spending to push up the deficit to GDP target to

2% and augment monetary stimulus being supplied by Bank Indonesia (BI).

Bank Indonesia to remain on hold.. for now

BI Governor Warjiyo has cut policy rates a total of four times so far this year, quickly walking back a good portion of last year's rate hikes in a bid to bolster sagging growth momentum. His recent comments point to the central bank keeping the door open to further rate cuts. But the 3Q GDP print will not likely push BI in that direction just yet given that it fell in-line with the market consensus. Warjiyo has noted that the current stance of the central bank remains "accommodative". But we expect central bank officials to closely monitor incoming data and reserve ammunition for further stimulus if growth momentum sags further, whether as a result of the trade war, or any other factor.

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Philippines: Inflation slides to 0.8%, likely to bounce next month

Philippine inflation dipped to 0.8% in October as base effects from last year's inflation peak kicked in. Inflation will likely rebound in the coming months as these base effects wash out.



Source: Shutterstock

Nowhere to go but up

Philippine inflation hit 0.8%YoY for the month of October, mirroring the peak seen in 2018 when inflation surged to 6.7%. Base effects played a major role in forcing the headline print below 1% for a second straight month, with heavyweights food and transport posting negative price inflation. Together the food and transport components combine to 46% of the CPI basket, posting negative inflation prints of -0.9% and -1.7%, respectively. But with the base effects from the peak of 2018 fading quickly, we expect inflation to revert to target as early as December.

Supply slide inflation

Supply-side bottlenecks are to blame for the inflation surge in 2018 with the components of food and transport posting inflation prints as high as 9.7% and 8.9%. With improved weather conditions, rice tariffication and subdued oil prices now in effect, headline inflation has dropped rather quickly and is expected to remain benign given the outlook for both commodity prices and weather conditions.

BSP done for 2019, likely to ease further in 2020

After working quickly to reverse the aggressive tightening of 2018, Bangko Sentral ng Pilipinas (BSP) Governor, Diokno, is expected to resume easing monetary policy in 2020 as he looks to help give the domestic economy an added boost amidst the projected global slowdown. With inflation forecast to remain within target even after base effects wash out, BSP will continue to work to provide an environment conducive for economic growth for as long as the price objective is in hand. ING forecasts inflation to settle at 3.1% in 2020, paving the way for the central bank to cut policy rates by another 50 bps, with the first move expected in 1Q 2020.

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