Good MornING Asia - 9 July 2019

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Political stalemate hurts Thailand's economy

Three months after the General Election, politics still remains a key overhang on the Thai economy. With political logjams slowing the emergence of any...

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Powell put postponed?

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How far will Fed Chair, Jerome Powell, push back market expectations?

A stitch in time...

The first of two days of testimony to the US Congress from Fed Chairman Powell tomorrow could deliver what Asian markets want to hear - the sound of imminent easing - or alternatively, the threat of rates on hold. Currencies and stock markets are reflecting that unease today. I used to go to the IDR, INR and PHP as my bellwethers for market risk sentiment in Asia. I now go straight to the KRW and cross-check it against the TWD. The message today is an unequivocal "risk off".

Indeed, the KRW is such a sensitive indicator these days, that over the last twenty or so days, it has shifted from about 1196, threatening to break 1200, to under 1150, looking poised for a move to 1140, and is now back at 1181. In the process, it has undershot, and then overshot our end 2Q USDKRW forecast of 1180 by a mile, though it looks to have hit it on average. That's no consolation...but it reminds me of the joke of the three economists who go hunting...(perhaps I'll save this for another day though drop me a line if you haven't heard it).

There isn't a lot today that could impinge on the argument for or against easing, though I'd be tempted to take a close look at the small firm US NFIB survey. From red, if not white hot readings of labour tightness in recent months, the employment component of this for June, that is released before the rest of the survey, dipped back a little, with jobs hard-to-fill and compensation gauges both moving back a little. Take a look too at JOLTS job openings, for another snapshot of the labour market that may not be captured in the main labour report.

But even if this data stays robust or even strengthens, I think the "worry-ists" about the Fed are misinterpreting what Powell has been hinting at doing. Powell is offering to provide an "insurance cut", or maybe two. Think about insurance for a minute. You don't take it out because you think your house will catch fire. But because you hope it won't, but don't want to be caught out if it does. (See also our monthly central Bank Watch on this).

Powell need not think the economy is heading into recession to deliver 25bp or even eventually 50bp of insurance easing, but he believes that easing in this way will keep the US economy on its current growth path.

Therefore, it makes no sense for Powell to wait until September to provide such insurance, as this is not a data dependent decision, but a risk-management one. By September, there may be other arguments for some easing. But as Powell says, an "...ounce of prevention is worth more than a pound of cure...", or something like that anyway. I might also add, "A stitch in time saves nine", though that may just be too esoteric.

Powell speaks today - but not on monetary policy. No Q&A, we have to wait this one out.

BNM - nothing today

One central bank that is probably not waiting on the Fed and Powell is Bank Negara Malaysia (BNM), who we expect to stay on hold today. As our Prakash Sakpal writes: "BNM announces its monetary policy decision at 3 pm local time today. We are part of a solid consensus forecasting no change to policy rates. In a pre-emptive move at the last meeting in May, BNM cut its policy rate by 25bp to 3.00%. And it has also just eased guidelines for bank lending to SMEs. The economy is holding up well, and growth likely picked up in 2Q from 4.5% in 1Q. Inflation also continues to be negligible, allowing plenty of space for more easing if required though we believe BNM will save this space for the future".

Other Asia data today

Japan's labour cash earnings for May were -0.2%YoY. This series is barely worth watching right now as the sampling methodology has been extensively modified to better reflect the prevalence of lower paying small firms in the economy. Consequently, year on year comparisons are garbage. It's better that we ignore this for another year until we have a series that makes sense. Though this is a pity as it was one of the more helpful pieces of data for forecasting the Japanese economy.

Note also the World Bank has just warned of potential political risk on Thailand, which could threaten currently strong markets. For a more detailed discussion of that issue, please check out Prakash's note that went out yesterday.

China's money supply is the other possible release today, with many recent easing measures undertaken subsequent to these June data, we probably can't read too much into this release, whenever it emerges this week.

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ASEAN Morning Bytes

General market tone: Wait and see. Asian markets will likely tread water on Tuesday ahead of Fed Chairman Powell's testimony.

EM Space: All eyes on Fed Chairman Powell's congressional testimony

- **General Asia:** Investors will likely opt to keep to the sidelines ahead of Fed Chairman Powell's testimony to the Congress as hopes for deep rate cuts are being scaled back. With the data release calendar thin before Wednesday, anxiety has built up and will likely keep investors from making any substantial bets.
- **Malaysia:** Bank Negara Malaysia, the central bank, announces its monetary policy decision at 3 pm local time. We are part of the solid consensus forecasting no change to the BNM policy. In a pre-emptive move at the last meeting in May, the BNM cut its policy rate by 25bp to 3.00%. And just It has also eased guidelines for bank lending to SMEs. The economy is holding up well with growth likely picked up in 2Q from 4.5% in 1Q. And inflation continues to be negligible, allowing plenty of space for more easing if required though we believe the BNM will preserve this space for the future.
- **Indonesia:** Growth targets in Indonesia have been lowered for 2020 to 5.2-5.5% (from 5.3-5.6%) given the current global outlook on the US-China trade war. Meanwhile, the government expects the IDR to trade within the 14,000-14,500 range next year while inflation will settle within the 2-4%.
- **Thailand:** The Bank of Thailand Governor Veerathai Santiprabhob told media yesterday that

the central bank was ready to adjust policy, noting that the benchmark rate could go up or down depending on what the central bank sees suitable for the economy. The economy is sputtering and the next move in the BoT policy rate will be down, in our view. We anticipate two 25bp cuts to the policy rate in August, and in the fourth quarter, taking it to 1.25% by end-2019. Echoing our view, the World Bank has warned prolonged political uncertainty as being a key risk for the economy ahead (see our "Political stalemate hurts Thailand's economy").

- **Philippines:** Government spending rose 6% YoY in May following the passage of the spending bill. However, the year-to-date spending is still down by 0.8% YoY, dragged down by 4% contraction in infrastructure spending, a key component to the administration's flagship build-build-build agenda. We expect sustained soft spending growth pushing the central bank for another policy rate cut in August.

What to look out for: Fed speakers, US inflation data

- Malaysia BNM meeting (9 July)
- US JOLTS jobs opening (9 July)
- China money supply (9 July)
- China trade (10 July)
- Fed Bostic and Powell speak
- Philippines trade (10 July)
- US wholesale inventories (10 July)
- FOMC meeting minutes (11 July)
- Fed Bullard speaks
- US inflation (11 July)
- Singapore GDP and retail sales (12 July)
- Malaysia industrial production (12 July)
- Japan industrial production (12 July)
- India inflation (12 July)
- US PPU (12 July)
- China trade (12 July)

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Article | 8 July 2019 FX | China

China gets net capital inflows

China's most recent foreign reserves show net inflows. How is this possible with the ongoing trade and technology war? Will net capital inflows affect the yuan exchange rate?

Foreign reserves on the rise

China's foreign reserves have only edged down slightly in one month this year (April). In June, reserves increased by another US$18.23 billion to US$3119.23 billion, the largest monthly increase this year.

Inflows have been stronger than outflows

China has been very closely monitoring capital outflow transactions, which helps explain the low net outflows in 2019. But this is only one side of the story.

Another is the weak dollar: This increases the USD holdings of other currencies and therefore raises the value of China's foreign reserves. This could be increased further as China has shifted to greater non-USD holdings in its FX reserves this year.

A more important factor is the inclusion of China assets in global benchmark indices.

1. A-shares inclusion into MSCI, which attracts passive funds to load up A-shares.
2. FTSE Russell kicked off the first phase of A-share inclusion in late June.
3. Onshore bond inclusions into Bloomberg's Aggregate Index, is similar to A-shares inclusion

into MSCI.

4. Then Chinese regulators increased RQFII quotas (renminbi qualified foreign institutional investment quotas) for foreign investors to invest directly into the onshore market.

The IMF estimated that equity and bond funds, passive and active, will create inflows of as much as $450 billion into China in 2019-2020, which is equivalent to 3% to 4% of GDP.

These actions make net inflows rather than net outflows more likely to happen for the rest of 2019, and possibly on into 2020.

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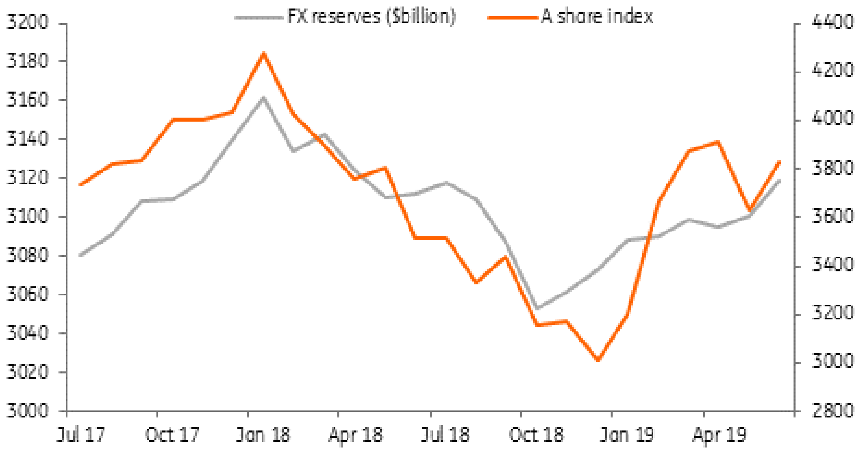
https://blogs.imf.org/2019/06/19/china-deepens-global-finance-links-as-it-joins-benchmark-indexes/

How will continuous net inflows affect the yuan exchange rate?

In a free-floating exchange rate mechanism, continuous net inflows into China should lead to yuan appreciation. But the yuan mechanism does not operate like this.

The yuan has a daily fixing rate that determines the yuan path each day. And the central bank has window guidance on the fixing rate every day. That means that the yuan exchange rate is not under a free float. Net inflows need not result in an appreciating currency.

China foreign reserves and foreign inflows into A-share index



Source: ING, Bloomberg

We expect the yuan to be stable

So what should the central bank do with the yuan when there are net inflows and at the same time the economy is facing a trade war and, perhaps as importantly, a technology war?

Well, precisely because of these reasons, the central bank will most likely keep the yuan stable. A stable yuan means that the authorities can focus on dealing with the trade and technology war, and not get distracted by currency volatility and capital flows. A stable currency is also arguably a less provocative currency policy during delicate trade negotiations.

We, therefore, continue to believe that the USDCNY and USDCNH rates will continue to be range-bound between 6.90-6.95. Our expectation is 6.95 for end 3Q and 6.90 for end 4Q.

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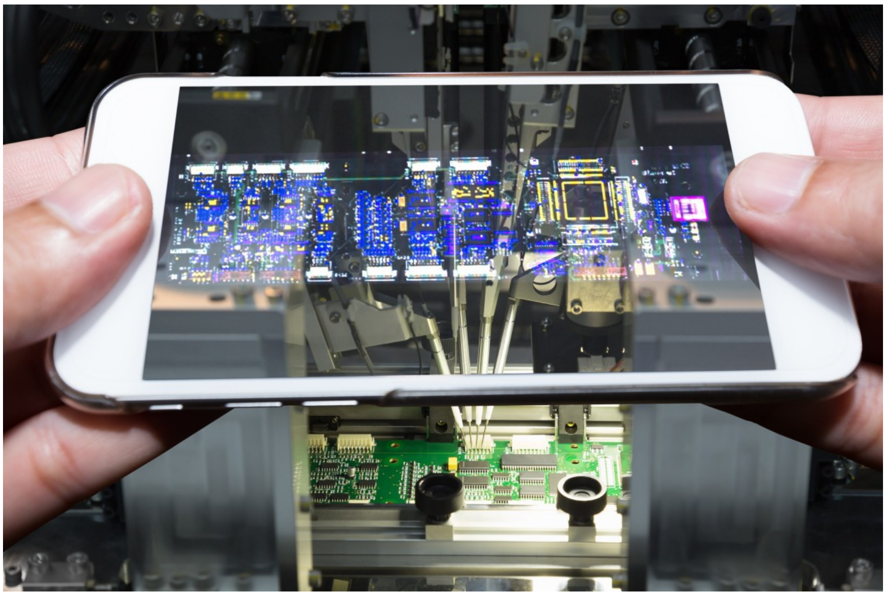
Taiwan: Export growth positive but too soon to celebrate

June data shows that Taiwan's import and export growth has turned positive again. We believe that structural issues tied to the smart phone product cycle and weak demand for these products will continue to impact Taiwan's manufacturing and export sector. Can 5G help the economy?



Source: Shutterstock

Exports and imports grew again but too early to celebrate

Imports rose 6.6% year-on-year while exports finally ended a seven-month stretch of negative growth, with a 0.5% rise. As imports grew faster than exports, the trade balance fell to $3.87 billion in June from $4.49 billion in May.

Still, it is too early to celebrate. First, the positive growth of exports is mainly due to a technical low base effect. Second, we doubt that the moving of factories from Mainland China to Taiwan will change the landscape for trade.

Taiwan puts too many eggs in one basket

Taiwan's export-related manufacturing - from chips to screen panels to cameras - is closely linked to the smart device product cycle.

Taiwan has put all of its eggs into this manufacturing basket. When the industry falls into a structural downturn, as it is now, manufacturing is severely affected. Smart devices are relying on adding more camera functions to win over customers, but that alone has its limit.

Exports of smart phones in August and September will be an important indicator of how well the economy can ride out this low demand cycle. If sales over this period don't exceed last year's exports, 2019 as a whole could see exports shrinking, which will directly hit the economy.

Does moving factories from Mainland to Taiwan change the landscape?

The Taiwan government has encouraged manufacturers to move their Mainland China production lines back to Taiwan. There are hopes for a material increase in manufacturing activities after heavy investment in moving factories.

But this would really only be possible if the US continued to impose further tariffs on Mainland China, especially on electronic devices. If the US-China truce continues, the moving of production lines, which is very costly, may be for naught.

Imports of capital goods and equipment grew 41.6% YoY in June, which is a bit exaggerated by the low base effect, and could slow again if export orders do not exhibit growth in August and September.

Moving production lines back to Taiwan does not solve the key issue that the country faces, which is a lack of diversification.

Even worse, this will increase tensions between Mainland China and Taiwan.

A structural issue has created a cyclical problem

The cyclical economic downturn is a by-product of the structural issues in Taiwan whereby the whole economy is dependent on exports of electronic products.

5G could be the future engine of Taiwan manufacturing

Still, we are not too pessimistic about Taiwan's economy so long as there are other economies refusing to use Mainland China-made 5G products. Taiwan can tap this opportunity.

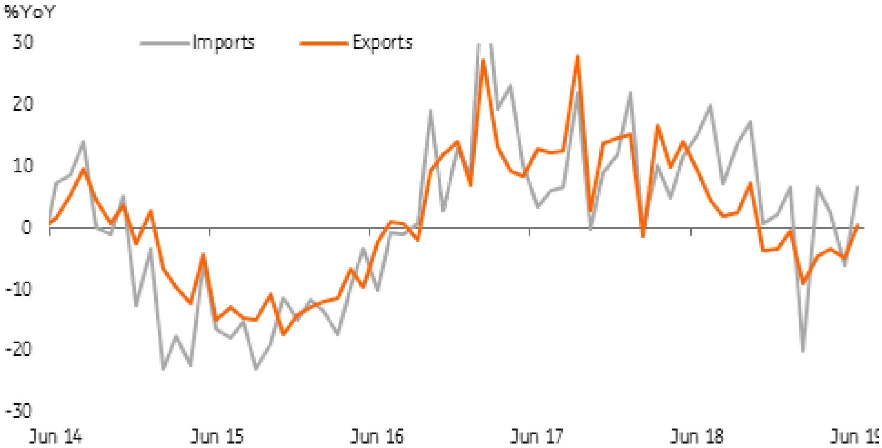
The manufacturing of equipment to produce 5G chips and infrastructure-related products should begin in 2020. We realise that this may be a bit late for the economy, but at least Taiwan should grow faster next year.

Before then, however, exports will continue to get worse.

The currency can't help exports very much. We expect the USD/TWD to rise to between 31.5-31.7 for the rest of 2019, which could only help exporters' margins by around 1.60% from the current spot exchange rate of 31.198.

As such, we continue to expect GDP growth to slow from 2.63% in 2018 to 1.8% in 2019, after which we think 5G will begin to help the manufacturing sector and lead the economy to 2.0% GDP growth in 2020.

Taiwan trade has yet to be confirmed a rising trend



Source: ING, Bloomberg

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Political stalemate hurts Thailand's economy

Three months after the General Election, politics still remains a key overhang on the Thai economy. With political logjams slowing the emergence of any fiscal stimulus, monetary policy will have to do all the heavy lifting to prop up growth. We now anticipate two central bank policy rate cuts before year-end

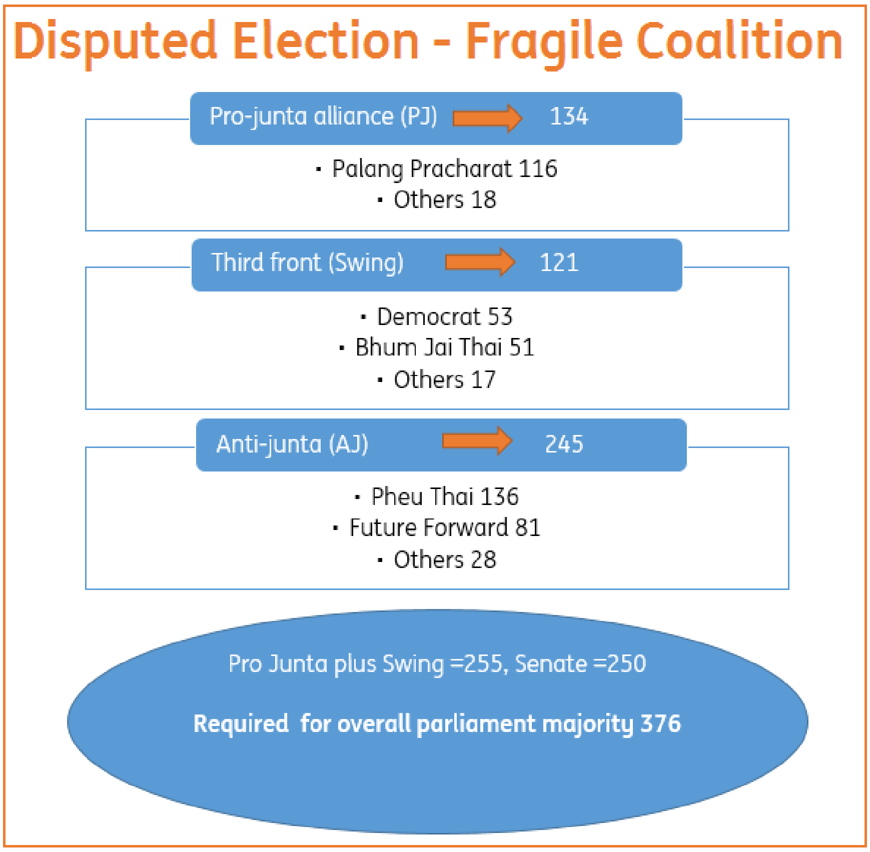
Source: Shutterstock

The political scene continues to be confused

The results of the General Election held on 24 March were widely disputed. And more than three months later, there is still no government in place.

The new parliament is comprised of the 250-seat Senate, entirely held by the military appointees, and the 500-seat lower house. Here, the pro-junta Palang Pracharath Party has managed to form a 19-party coalition holding a very slim majority of only four seats. This Parliament formally elected Prayuth Chan-Ocha as prime minister – the former military general's second term in that office. We thought this had almost ended the long-standing political uncertainty since the 2014 coup. But we were wrong.

Disputed elections - fragile coalition



Source: ING

As the wrangling for cabinet positions and tumult with his own political circle continues to delay formation of the government, PM Prayuth has hinted at a mid-July timeline for instituting his new Cabinet. However, it doesn't look to be going well, given recent reports of a rift within Prayuth's Palang Pracharath Party, as well as the Constitutional Court's order for investigation of 32 lawmakers from the ruling coalition for violating the constitutional prohibition of shareholdings in media companies.

The Court has allowed all 32 embattled lawmakers to keep their seats until the final ruling, an implied leaning towards the junta which faced criticism from the opposition, given the Court's earlier suspension of a main opposition party leader for the same allegations. Thanathorn Juangroongruangkit, the leader of the Future Forward Party, is currently being investigated by the court for his media holdings.

> *I hope that everything will move forward to respond to peoples' needs as the government of all Thais. This will be a beginning for a political reform by the government and its coalition so that politics will not get back to its old problem that might require the old, unwanted solutions – PM Prayuth Chan-Ocha*

These recent developments could potentially destabilise the coalition, reducing it to a minority and thus paving the way for more uncertainty ahead. The additional risk stems from factions within the military, the imminent shift of power away from the Queen's Guards, from which PM Prayuth hails, to the King's Guards led by military commander-in-chief Apirat Kongsompong. The latest story by Nikkei Asian Review will be a good read on this (may require subscription).

So, where do we go with all this? Prayuth's mid-July timeline for having the government in place may seem a bit optimistic. We aren't judging the hopes of a return to the civilian regime as being in vain. but even if it gets there, Prayuth will still be leading a very weak coalition government that would face tests during the passage of key legislation in parliament, e.g. the imminent 2020 budget. After all, with such a fragile coalition, doubts about the new government surviving its entire term will flourish.

On the other hand, if the process is dragged out beyond July, we could be in for quite an unpredictable political future, which would come as a significant dent to investor confidence in the new political machinery. We don't rule out a further spike in political risk.

Against such a backdrop, the strong rally in local financial assets – government bonds, equities and the Thai baht alike – underway since June, remains at risk of being unwound.

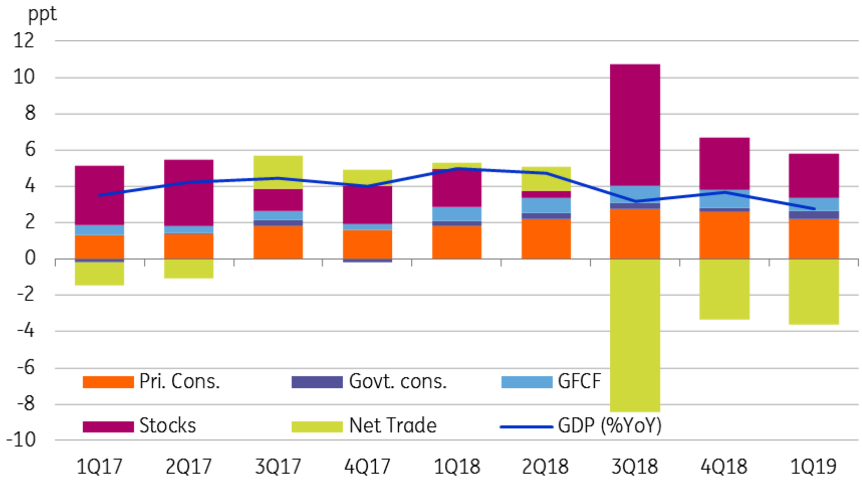
The economy isn't doing any good either

Following on the heels of an exceptionally weak first quarter this year, the economic data continues to unfold on the weaker side. GDP growth slumped to a four-year low of 2.8% in 1Q19. The political jitters during the general elections weighted on domestic demand, while global trade and the technology war continued to depress exports. Indeed, net trade remained a key drag on growth. If it weren't for a sustained inventory re-stocking, GDP growth would have been even worse.

We read the high-frequency activity data as signalling continued economic weakness in the current quarter, while the forward-looking confidence indicators show no respite from this trend over the rest of the year.

Besides weak exports, a further hit to growth comes from the fallout of the trade war on the tourism sector - the backbone of the Thai economy. This is already evident from the slowdown in Chinese visitors underway since last year. Domestic political jitters also deter tourists and GDP growth.

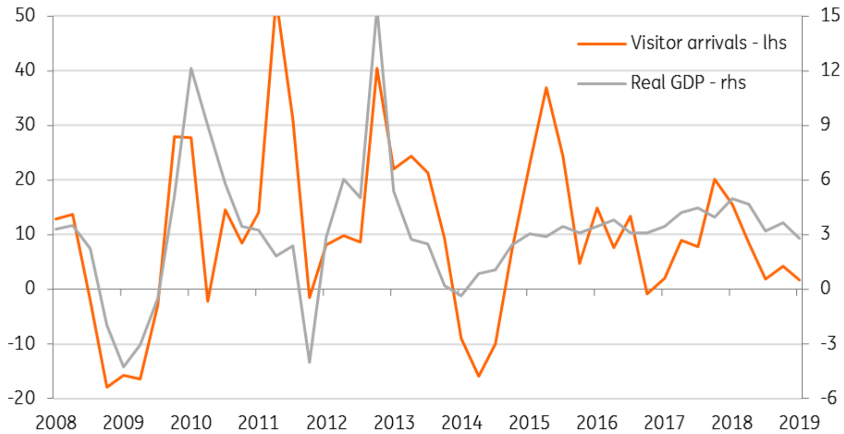
Sources of GDP growth



Note: Bars may not stack up to GDP growth due to statistical discrepancy

Source: CEIC, ING

Slowing tourism, slowing GDP growth (% year-on-year)



Source: Bloomberg, CEIC, ING

Cloudy prospects ahead

We recently revised our GDP growth forecast for 2019 to 3.1% from 3.8%, putting it below the official 3.3% forecast by both government and the central bank (the Bank of Thailand) which were scaled back from 3.8%.

Meanwhile, inflation has remained subdued, making the last rate hike seem even more unnecessary. Weak growth will sustain the low inflation trend for the foreseeable future. At an average rate of 0.9% in the first half of 2019, consumer price inflation was slightly below the 1% average in the same period last year. A sharp spike in food inflation was more than offset by a slump in housing and transport inflation, while inflation in other consumer products (core inflation) continued to be negligible, about 0.5%.

We expect the inflation outturn for the rest of the year to remain benign, especially with strong currency appreciation this year keeping imported inflation at bay and anaemic domestic demand limiting any upside at home. The Commerce Ministry recently cut its 2019 inflation forecast to 1.0% from 1.2%, putting it on a par with the central bank's forecast. Our 1% annual inflation forecast maintained since the last revision from 1.3% in January this year, remains on track, though with the risks tilted more to the downside than to the upside.

Subdued inflation

Source: Bloomberg, CEIC, ING

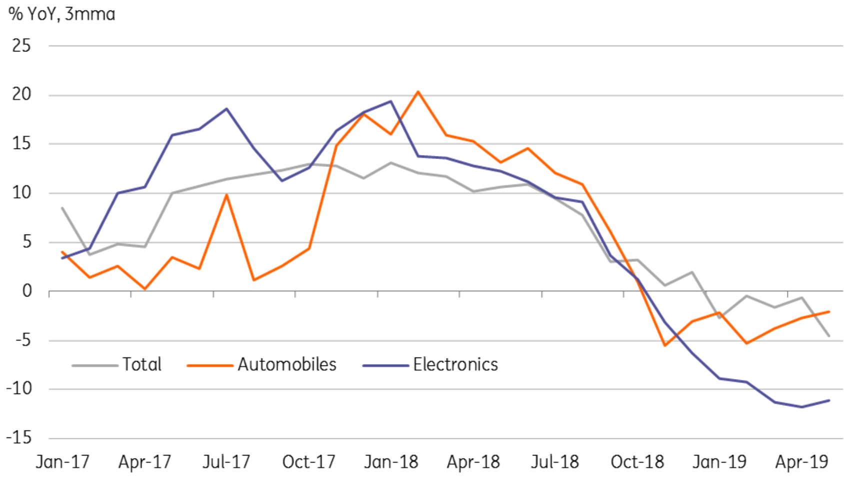
Still, healthy external payments

Thailand isn't spared from the US-China trade and technology war or the global tech slump hanging over the entire region. Exports of automobiles and electronics, together accounting for 30% of total exports, have been on a steady downward grind.

A 2.7% YoY contraction of total exports in the year through May is a significant negative swing from 12% growth a year ago. The swing is much worst for imports, - 1.0% YTD from +16%, which underscores domestic economic weakness. This is associated with a (just slightly) narrower trade and current account surplus than a year ago.

The potential negative impact on the "tourism dollar" could mean that the surplus narrows even further. We foresee the annual current surplus in 2019 to be equivalent to 4.8% of GDP, down from 6.4% in 2018. This is still large relative to most Asian countries and remains a significant support to the currency (Thai baht, or THB).

Slumping automobile and electronics exports



Source: Bloomberg, CEIC, ING

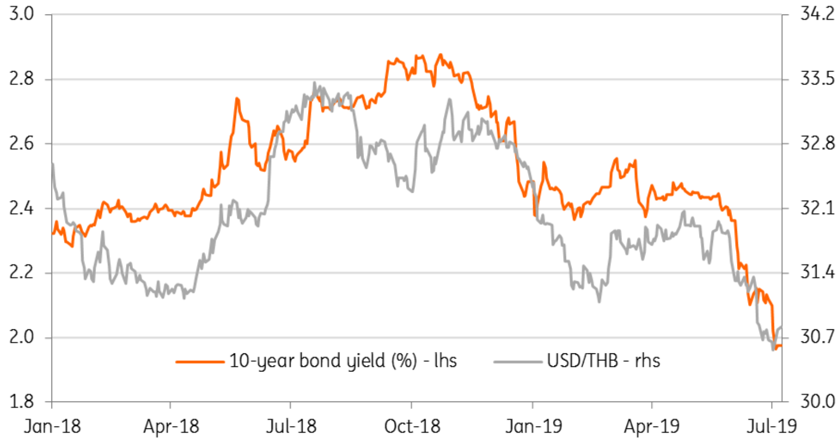
Excessive baht strength hurts more

The THB continues to be among the best performing emerging market currencies so far this year, with a more than 6% appreciation against the US dollar, taking the exchange rate to a six-year high of 30.57, even in the face of heightened global economic and geopolitical uncertainty. Clearly, the THB performance is out of sync with the underlying weak economic trends despite the fact that the currency enjoys a relatively strong backing from the large current surplus, which itself is a by-product of a significant economic imbalance – perennially weak domestic demand.

The BoT attributes recent (fast-paced) appreciation of the THB to a weakening US dollar, short-term capital inflows, and domestic factors. But the central bank also admits to it being inconsistent with economic fundamentals. It's not just inconsistent with prevailing economic fundamentals, the strong currency further dampens the prospects for exports and tourism by making them more expensive for foreigners. Thailand's status as a cheap tourist destination in Asia and perhaps the world is under threat from rapid currency strength.

Indeed, the authorities are worried about this runaway currency appreciation but there is little action to arrest it just yet, even as Thailand has now moved out of the US Treasury's radar for currency manipulators. The BoT is only 'closely' monitoring the foreign exchange market for speculative interests. We believe a policy rate cut might help in the process while the argument for easing is getting stronger and stronger with every piece of additional data.

Surging portfolio inflows



Source: Bloomberg, ING

Lack of fiscal support

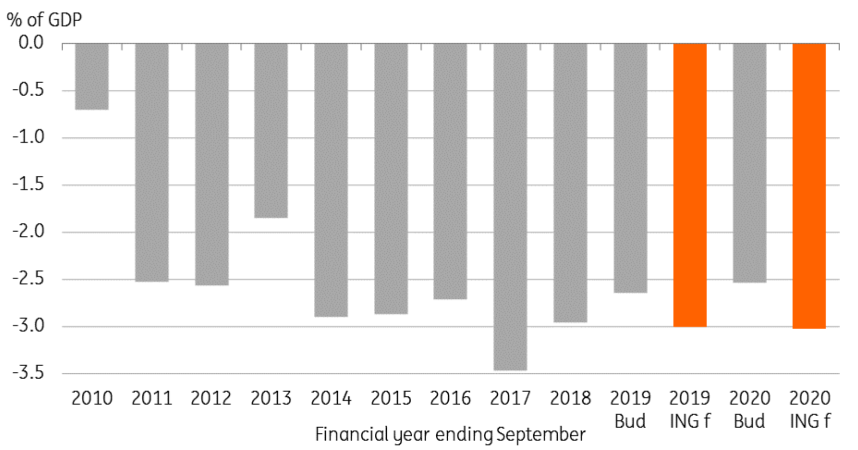
The persistent political uncertainty reduces hopes for any fiscal stimulus to revive the economy going forward, while the delayed government formation itself has been hurting routine government spending.

That said, the 4.4% year-on-year revenue growth in the first eight months of fiscal 2019 through May (fiscal year runs from October to September) was moderate but a bit slower than 4.6% in the same period of the previous year while expenditure growth of 5.6% accelerated from 0.1% a year ago.

Such trends will be associated with a significant overshoot of the fiscal deficit in the current financial year, above the government's target of THB 450 billion, or about 2.6% of GDP target. We see the deficit this year as unchanged from the 3% of GDP level it was in the last financial year.

Without a properly functioning government the fate of big infrastructure projects, like the Eastern Economic Corridor (EEC)- a $45 billion public-private partnership, hangs in the balance.

Fiscal deficit



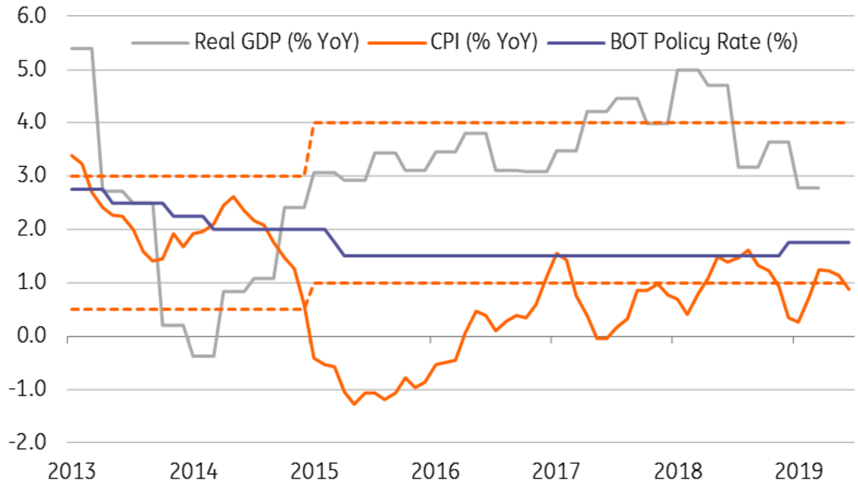
Source: CEIC, ING

Heavy-lifting for monetary policy

The BoT's last policy change was a 25 basis point increase in the one-day repurchase rate, the policy rate, to 1.75% in December 2018. We thought that policy tightening wasn't required in the first place when the external economic headwinds were already getting stronger, GDP growth was petering out, and inflation was running under the BoT's 1-4% target. Indeed, Thailand's economic environment hasn't got any better since the last policy move. Rather, it has deteriorated.

The lack of fiscal policy support means that monetary policy will have to do all the heavy lifting. Slowly but surely, the authorities are coming to terms with the need for easier monetary policy.

Growth, inflation and policy rate



Dotted lines are BoT's target for CPI inflation, currently 1-4%.

Source: Bloomberg, CEIC, ING

Just recently the government added its voice to calls for monetary easing, with Deputy Prime Minister Somkid Jatusripitak saying that "It can't go against the trend if the economic situation continues to be like this". And a BoT policymaker, Somchai Jitsuchon, signalled that monetary policy would be data-dependent, with the fallout from the US-China trade war on the local economy leaving the bank "open to all possibilities". This being the case, it's hard to imagine the BoT ignoring the latest activity data, which offers no hope of recovery in economic growth in the period ahead.

The BoT's statement after the last meeting was largely dovish and it was also accompanied by a downgrade of the central bank's growth forecast for 2019 to 3.3% from 3.8%. We take this as a signal that a policy rate cut is just around the corner. We continue to expect a 25bp rate cut in the current quarter, more likely at the next meeting on 7 August rather than the 25 September meeting. However, that would still only be a reversal of the hike in late 2019, and not provide much stimulus to a sagging economy. We are adding one more 25bp rate cut to our policy forecast in the fourth quarter, taking the policy rate to 1.25% by end-2019.

Thailand: Key economic indicators and ING forecasts

Thailand	2015	2016	2017	2018	2019 f	2020 f
Real GDP (% YoY)	3.1	3.4	4.0	4.1	3.1	3.5
CPI (% YoY)	-0.9	0.2	0.7	1.1	1.0	1.4
Unemployment rate (%)	0.9	1.0	1.2	1.1	1.2	1.1
Fiscal balance (% of GDP)	-2.9	-2.7	-3.5	-3.0	-3.0	-3.0
Public debt (% of GDP)	42.1	41.1	41.2	41.6	42.9	47.4
Current account (% of GDP)	6.9	10.5	9.7	6.4	4.8	3.1
FX reserves (US$bn)	156.5	171.9	202.6	205.6	220.0	230.0
External debt (% of GDP)	32.7	32.0	34.1	31.3	32.0	33.0
Central bank policy rate	1.50	1.50	1.50	1.75	1.25	1.25
3M interbank rate (%, eop)	1.63	1.59	1.57	1.86	1.50	1.65
10Y govt. bond yield (%, eop)	2.50	2.65	2.32	2.48	2.00	2.25
THB per USD (eop)	36.08	35.84	32.58	32.33	31.00	30.50

Sources: Bloomberg, CEIC, ING forecasts

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