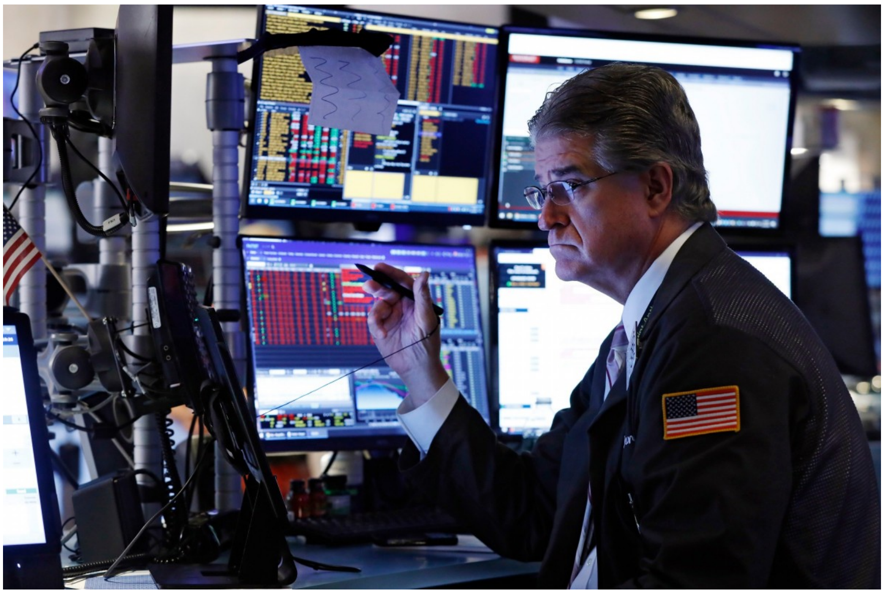
New conundrum could be good for Asia

With bond yields falling further, one explanation for this could indicate a more supportive environment for Asian economies.



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Low growth world ahead - I doubt it

As the world's most dynamic region, the Asian market concern about an approaching slow-growth decade - presaged by falling US Treasury yields is worth pondering, but only briefly. The explanation for this slow growth angst, given out freely by newswires this morning, seems to stem mainly from a single data release, the July US non-manufacturing ISM index.

The index did fall several points, but at 60.1, remains in what I would normally regard as an extremely healthy level. Moreover, this index is quite nuanced in that it is a measure of how the future will look relative to the past - will activity be "***stronger***"? Not necessarily "will it be strong". As such, it is subject to all the same vagaries as year-on-year measures, when the past is strong, the future may not show much improvement even when it is still in absolute terms "strong".

For the same reason as you cannot accelerate indefinitely, this index cannot point to ever-stronger growth indefinitely. No, there is really nothing in the ISM data that is worth a 7bp decline in Treasury yields.

Our Head of rates strategy, Padhraic Garvey, writes in his latest rates spark about this issue (ahead of the ISM data, which he rightly dismissed in importance) and he touches on an important aspect of what may be going on.

He notes that expectations for rates, even though rate hike expectations may have been drawing closer, do not rise very far. Indeed, if you look at simpler measures than he does in his note, for example, at the implied rates on the Fed funds contract as far out as you can go, rates don't even get to 1.25% by 2026.

This, it seems to me, could be the key message we should be taking away from recent market movements. Rates may well rise a lot sooner than many of us are expecting. In Asia-Pacific, the RBA yesterday seemed to undertake a shuffling of its positions to allow for some earlier forward guidance than it has been making. 2023 rather than 2024 may soon be the new guidance. But like the Fed, some may consider an even earlier hike a possibility.

The Bank of Korea, likewise has already indicated that it might like to start the normalization process this year. That still seems a bit aggressive to us while the jury is still out on Covid containment. But even here, we suspect that very high household debt levels in South Korea mean that rates may not rise much at all over the coming business cycle before they start to weigh on growth.

And elsewhere in the region, even when we don't see much imminent change in policy rates, where rates have been aggressively cut, some small reversals of emergency easing could come in sooner than expected, though may also stop well short of what we might consider a "tightening cycle".

So if longer-dated maturities are a function of the sum of shorter maturities, plus a term premium, which in theory, they are, then the rate at which longer-dated bond yields settles may not even be as high as the forecast peak in rates for this cycle, bearing in mind that there may well be subsequent declines. Can this conjecture square the circle with the pressure on prices we keep seeing? To some degree, I think it can. Sooner, but lower in total could well help us to reconcile what appears to be the new conundrum. It is also an outcome that is likely to be less hostile for Asian emerging markets, which would struggle more with a protracted tightening schedule by the Fed and major central banks, but could probably weather a shorter and capped tightening cycle better, depending on how the USD responds.

Dataflow today - not much

It is a quiet day today in Asia for data, with Taiwan trade and CPI data the highlights: Iris Pang in Hong Kong writes, "Taiwan trade data released today will likely point to faster growth, even during a month in which Covid picked up and led to stricter social distancing measures. And this is all because of the low base last year.

We also expect Taiwan CPI to edge down on a yearly basis, reflecting the impact of rising Covid rates on the economy, which would also match the higher unemployment rate released yesterday. The unemploymnent rate came in at 4.1% in May from 3.6% in April.

As a result, we expect a weaker TWD against the dollar as Covid continues to limit people flows".

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