War and peace

Making sense of Asian macro and markets
War and peace - making sense of Asian macro and markets

• Trade wars – the biggest threat to our Asian economic and market forecasts – are no longer just a scenario

• It’s worth stopping for a minute to consider why we are even here

• Addressing perceived trade imbalances is one of the Trump Administration’s key objectives

• Does this also resonate with the US electorate?

• If the US goes “all in” on a trade war, what effect will this have on China?

• How will this affect the rest of Asia?

• What is the likely US dollar impact...?

• How will this all end...?
Trade war – why are we here?
How we got here

• There are a lot of populist policies flying about the world right now, including from the Trump Administration. But why? And how does this translate into government changes?

• A simple (overly simple perhaps) explanation is that the ordinary public feel unhappy with their situation...

• ...there are good economic reasons why this is the case, but economics can only explain some of this. Policies that strike at foreign countries and immigrants are winning votes...

• ...some of this may be “hard-wired” into us

• We need to call up some of the other social sciences to help us, Philosophy, Psychology, Politics, maybe even a natural science, like Biology

• What follows, is a brief overview of the “Why?”

• We then turn to the “What?” and “How?”
What do people want?

- A fulfilling job
- Opportunities for self-improvement (education)
- To have some income left for life’s treats
- A decent place to live
- Peace of mind about retirement
- To be cared for adequately when sick
- To be able to provide the essentials for their families (with or without handouts)

• Here are some of the aspirations of ordinary people…(voters!)

• …today, many families in developed countries struggle to achieve just these “basic” aspirations, or feel that their children will be unable to achieve them...

• …judging that the “system” has failed them, some are looking for radical alternatives…”new” politicians are offering to supply them
Sources of unhappiness 1: Inequality

US income distribution by “quintile”

- Of course, it’s not just the US where inequality has risen, though it is perhaps best documented here.
- Inequality is also a growing problem within Asia.
Inequality – not just a US issue

- Some (poorer) Asian countries rank only a little behind the US on inequality measures such as the GINI coefficient.

- We show some other non-Asian countries for comparison.

- But even Sweden has had its issues – inequality is not everything! Rapid cultural dilution can be important too.

Sources: World Bank
National Bureau of Statistics
But if circles were incomes...

- In this figure, household income is reflected by the size of the circle.
- Assume “happiness = income”.
- For the same GDP, more people are “happier”.
- Although there may be fewer “very happy / ecstatic” people.
- Are much richer people much happier? Possibly not.
- Maximising GDP is a dumb policy goal, if you want to get re-elected.
- Maximising median levels of satisfaction would be much smarter.
- Does anyone really do this? Maybe the populists “appear” to do a better job, even if the reality is more debatable.

Key:
- Unhappy
- Content
- Happy
- Ecstatic

Unequal income / wealth distribution

Equal income / wealth distribution

The same GDP as...
Important, people vote, GDP doesn’t

- There will always be more “poor” than rich….more “unhappy” than “happy”, and despite lower voting tendencies, if they vote, they should always win…!
Sources of unhappiness 2: Labour share

Now I’m not a Marxist, anything but! But...
...in much of the world, GDP has risen while the benefits have often not been distributed evenly
Since 1970, the share of GNI (Gross National Income) accruing to labour (households) has fallen 6pp
The share to capital (profits) has risen by the same amount (funny that!)
This is a common theme across developed economies – not just the US (illustrated)
Lessons from a dead German philosopher

Thesis

Financial crisis and policy remedies

Anti-Thesis

Household economic hardship and inequality “unhappiness”

Synthesis

Support for populist politics

- Hegel’s dialectic helps shed light on what is happening
- In a nutshell – people are unhappy with what went before and their current standard of living
- The outcome now is discontent, manifesting in a surge in populist support
- We may be “hard-wired” to blame “others” for our own hardships, those outside our borders (foreigners, immigrants)...in other times, we may have gone to war
**Other sources of discontent:**

**Median incomes**
- Median household income growth is very weak, so for most people, living standards are stagnating, not improving.
- Even then, official measures of CPI used to deflate income probably overstate real income growth, and thereby “contentment, happiness”. But this probably overstates income and thereby “happiness”.
- Deflated by “essentials”, income has barely risen at all in some developed market countries in the last three to four decades.
- Costs of self-improvement – education, health, have all risen far faster than the headline – so if you are in a low income bracket, you may be stuck there…depressing, frustrating...

**De-industrialisation**
- Manufacturing jobs as a percentage of total jobs in G7 countries keep falling – they have been falling since the end of WWII. They will likely keep on falling.
- Problematically, outside finance, manufacturing was typically the highest earning sector (with the fastest productivity growth). As those jobs have disappeared, they've been replaced by poorly paying service sector jobs, and wage growth in even these sectors has slowed (Balassa Samuelson effect).
- Automation, not globalisation is the biggest factor here.
- But what is actually the cause, and what people believe is the cause need not match up to be important for how people vote.
Trade wars

- Trade wars are unsupported by economics. Tariffs are a tax on imports, they make most of us poorer.

- This is about the ONLY thing reputable economists agree on.

- But though most people gain from free trade, not everyone does.

- There are always some losers, and they may lose more individually, and far more obviously (painfully) than the micro-gains of the millions of others.

- The gainers are also typically already in good, well paid jobs, or are the owners of capital.

- A trade deficit is not BAD, and a trade surplus is not GOOD. But it is easy to portray them as such, and provide a justification for a “just trade war” ... “Retribution” for those who lost their livelihoods, and “protection” for those at threat of losing theirs.

- Economics tells us that the likely outcome of a trade war is lower disposable income, lower profits, higher prices, and therefore, probably higher interest rates and a stronger currency...

- ...and therefore, no improvement in the trade balance...but does that really matter?
The “World” Trade War

The combatants in this global trade war are centred on 3 main regions:
1. North America
2. EU
3. Asia (China, but also Korea, Japan)
4. Add in Turkey and Iran, (Brazil, Argentina, exempted tariffs but quotas on steel, Aluminium exports)

There are four main “battles” in this war (see next slides...)

- US
- Everyone else on the receiving end
Trade War – Battle 1: Solar Panels – Washing Machines

Jan 22 2018
US implements “safeguard tariffs” on solar panels and washing machines – aimed at Korea though some fall out to China’s solar panel industry

May 14 2014
Korea files challenge on “Safeguard tariffs” through the WTO claiming violation

April 17 2018
China implements 178.6% anti-dumping duties on US Sorghum wheat

May 2018
China ends tariffs on US Sorghum during negotiations with US Trade team

• This battle was really only a warm-up act for what followed. It was not directly aimed at China, but the Sorghum anti-dumping tariff can be seen as an early indication that China will not roll over on trade issues

Source for Timelines: Peterson Institute guide
https://piie.com/blogs/trade-investment-policy-watch/trump-trade-war-china-date-guide
Trade War – Battle 2: Steel and aluminium

1 Mar 2018
Trump announces forthcoming tariffs of 25% on steel and 10% on aluminium covering $48bn of imports (only 6% of which from China)

7 Mar 2018
EU Threatens to ‘rebalance” in retaliation through the WTO on cranberries, jeans, Harley’s and bourbon

8 Mar 2018
Nafta exempted from tariffs pending successful renegotiation talks

22 Mar 2018
EU, S. Korea, Brazil, Argentina, and Australia also exempted, until 1 May

23 Mar 2018
Tariffs on other countries go into effect

30 Apr 2018
US extends tariff exemptions to 1 June

2 April 2018
China imposes retaliatory tariff on aluminium waste and scrap, pork fruit and nuts on $2.4bn imports (vs $2.8bn steel and Al exports)

28 Mar 2018
Korea gets permanent steel tariff exemption, but faces quota of 78.8% 2017 export volume

1 June 2018
Tariff exemptions expire for EU, Canada and Mexico (half of US steel and aluminium imports in 2017)

22 June 2018
EU imposes “iconic” tariffs 34% steel and aluminium, the rest jeans, corn, whiskey etc

1 July 2018
Canada strikes back with tariffs on $12.8bn of imports (steel and aluminium, but also agriculture, foods and consumer goods
Trade War – Battle 3: Technology, IP

18 Aug 2017
USTR Lighthizer self-initiates investigation of China under Section 301 following Trump memorandum

22 Mar 2018
Results of investigation conclude China acting unfairly on tech transfer, and innovation. Trump indicates $60bn in forthcoming tariffs on China

3 Apr 2018
US Administration unveils list of 1,333 Chinese products considered for 25% tariff (mainly machinery, mechanical, electrical) – hits US supply chains

4 Apr 2018
China threatens retaliation on autos, aircraft and agriculture (soybeans)

5 Apr 2018
US considers additional tariffs on $100bn

18 June 2018
Revised list of products released, on $46.3bn goods – mainly intermediate goods.

20 May 2018
Mnuchin says tariffs are “on hold”

15 June 2018
China announces retaliatory list $45bn at 25% (mainly agri). 2 phase approach, $29.6bn on 6 July, rest (mainly energy, petro-chems) later

10 July 2018
USTR releases list of $200bn of Chinese imports for new 10% tariff to be implemented after public hearings in August

18 June 2018
Trump directs USTR to identify an additional $200bn of tariffs

29 May, White House announces tariffs on $50bn of Chinese goods once final list announced

15 June 2018
Revised list of products released, on $46.3bn goods – mainly intermediate goods.
Trade War – Battle 4: Autos threat to security (!?)

23 May 2018
Commerce department initiates national security investigation into imported autos and parts. Public hearings scheduled for 19-20 July. Trump reportedly considering tariffs of up to 25%. Tariffs could affect $208bn of imports, none from China, nearly all from US allies

Date
Result and response yet to be determined

- This one has barely got started yet, but we might consider it alongside other investigations such as the importing of uranium as a security threat – would likely drag in EU, Japan, Korea.
So far, the trade war is pretty one sided.

Actual tariffs implemented amount to only about USD $165bn of trade at tariff rates of between 10% and 25% (excludes the $200bn Section 301 tariffs)

Threatened tariffs not yet implemented amount to a further USD$340bn (plus up to $200bn of the section 301), at similar tariff rates...

... for a total of about USD $700bn. For comparison, Global GDP is about USD$80tr so tariffs equivalent to <1% global GDP.
EM Turmoil
...markets / growth
Trade policy on currencies – stronger USD

...Weaker Asian FX

- The balance of trade / current account, is defined as the difference between savings and investment
- The US deficit primarily exists not because of “unfair trade”, but because the US consumes more than it produces
- A tariff will result in a stronger dollar, not necessarily a better trade balance, nor stronger growth
- It will result in weaker currencies for all “victims” of tariffs, e.g. much of Asia

$ at eqbm

$ at eqbm

$ after tariff

$ after tariff

Investment / savings function 1

Investment / savings function 2

GDP, including net exports
(surplus / deficit)
Asia and trade – it’s not looking helpful

- Asian FX is highly sensitive to global trade flows – not surprising as 1/3 of global trade passes through this region

- Falling trade means weaker currencies

Source: Bloomberg, ING
What happens when your currency weakens...

- No guarantees, as there are a lot of leaks in this transmission mechanism, but weaker currencies can result in higher inflation, and for some economies, this may require some central bank rate response.

- Already seen movement by central banks in Indonesia, Philippines, India...more coming...
FX sensitivity – don’t forget commodity prices

- Exchange rate sensitivity to trade is not evenly distributed in Asia
- We find the commodity currencies (MYR and IDR) have historically been more sensitive to trade fluctuations - the additional commodity overlay seems to be important
Tariffs and Asian growth – not just an FX issue

- Although we have already seen rate hike responses from the central banks of Indonesia, Philippines, and India, we expect more from them later this year and in 2019

- Next on the list is to reconsider the “no hike” calls for economies such as Malaysia, Thailand, and Korea

- Could they be “forced” to move if their currencies weaken much further? Never say never...
Tariffs and growth – also depends on export dependency

- Being rich is not necessarily a defence, if you are also highly open and dependent on trade, as is the case for Singapore and Hong Kong
EM turmoil – Indonesia is nothing like Turkey

This Bloomberg graphic neatly encapsulates the Asian Emerging Market issue

Turkey: US tariffs will weaken the Turkish lira – this creates serious problems for it, and any other similar country through contagion. Argentina has its own problems

Indonesia is Asia’s most similar economy, with Philippines, India also at risk, but all of them are far stronger structurally
We typically think of China as an exporter of finished goods and intermediate products to the US and to Europe.

But as tariffs bite, US trade flows are likely to be diverted:
1. To nearby Asian economies (squeeze local production?)
2. To traditional destinations, but indirectly (Asian shipping could benefit) – could “near-China” economies benefit... Vietnam?
China – impact and response
Rising risks could affect China growth

Trade war impact:
1) Delayed investment decisions made by trade related companies
2) Trade volume ↓ and prices↑ (ease of finding a substitute would affect price increase)
3) Impact on supply chains

Financial deleveraging impact:
1) Bond market default risks ↑
2) Tighter credit
3) Tighter liquidity
4) Counterparty risk ↑
5) Slower credit growth –ve on economic growth

That's why the proposed asset management policies have been relaxed
China’s possible reaction

... shhhhh... China has started retaliating quietly

Won’t give in on tariffs
Continue to maintain announced tariffs if US does not withdraw its tariffs on Chinese goods

But open up markets only seemingly to benefit US
Open up markets that are less relevant to the US than to the rest of the world
• Eg. Cosmetics (Korea, Japan, Europe), healthcare (Europe), energy (Belt and road economies)
Or already mature in China
• E.g. payment platform companies, which are difficult to compete with existing Chinese peers in the China market
• E.g. Automobile manufacturers' profits already falling on a year-on-year basis

Retaliation on US companies for what ZTE experienced in US
Foreign entities in China are restricted from transferring their scientific research data abroad, this may hurt international scientific collaboration, but this hits US pharmaceutical companies the most.
• Multinationals eyeing China's pharmaceutical market, worth US$122.6bn in 2017, according to healthcare research group IQVIA, will also see a higher cost of entry.
• Regulations are too vague and too broad for interpretation. (English version of the regulation is here)

Speed up China Manufacturing 2025
Build hard-core technologies to achieve Made in 2025 even earlier
• E.g. To enhance its ability to substitute imports of chips, and even more, to export high-tech chips in the future
• This will increase fixed asset investments in China to offset the loss of net exports and related economic activities.
• We may not see slowdown in GDP growth but the structure of growth would change.

• Potential qualitative response – hard to put a dollar-figure on – but also open-ended

• Not to be underestimated
Some exporters will turn inward

But some could be out of business if their products are not welcomed by Chinese consumers

- Although the contribution to GDP from “net exports” is pretty small these days...
- ...do not underestimate the potential damage from large-scale trade wars on investment and employment activity
- This is a non-linear relationship (damage grows disproportionately to the scale of the war)

Net export of goods & services contribution to GDP growth

- Direct impact on trade seems small
- But it would also hit manufacturers and suppliers, like packaging and logistics
- Exporters’ worry will also result in delayed business expansion (investment)
Expect more fiscal stimulus even though government debt is rising

Deleveraging relegated in importance as credit / fiscal policy used to offset impact of trade war.

China’s high leverage problem originates from corporates but will move towards government in order to fulfil Xi’s plan.

Updated on 20th August 2018

Total credit is 239% GDP down from 262% in Feb 2017

Corporate credit 104% GDP down from 120% in Feb 2017

Gross government debt 83% GDP Up from 50% in 2016

Household debt 52% GDP Rising from 40% in Feb 2017

Nominal GDP ¥86.5trn or $12.7trn in 2Q18 (rolling 4 quarters) (exchange rate 6.80)

Still high, but has come down because of overcapacity cuts, and we expect this will keep this falling.

This is a new risk on our radar, to improve rural living standards, local governments will increase debt, and the central government would eventually bear some burden.

Although household debt rose due to an increase in property investment, the government has imposed measures to limit this risk, including watching out for new risks arising from fintech-driven personal loans.
No Panic in FX market - no 2015 re-run

- Weakening CNY has not led to outflows this time
- Restrictions on outflows binding and working
- Seen as policy choice, not market meltdown

Moreover, CNY has generally tracked DXY move
This has been about USD strength, not CNY weakness

...or here
Trade war effects –
- more ex-US deals, more FDI?
TPP is a comprehensive agreement, affecting trade in goods, rules of origin, trade remedies, technical barriers to trade, trade in services, intellectual property, government procurement and competition policy.

It called for a 90% reduction of all tariffs between member countries by 1 January 2006, and reduction of all trade tariffs to zero by the year 2015.

The TPP is considered to be a pathfinder for the proposed Free Trade Area of the Asia Pacific (FTAAP), an APEC initiative.
US never in RCEP (Regional Comprehensive Economic Partnership)

RCEP is the world's largest economic bloc – covers 39% of global GDP – bigger than TPP

Accounts for population of 3.4bn. An alternative to the TPP, US withdrawal from TPP increases chance for RCEP to succeed, could be signed this year
Global FDI stocks – Asia (Europe biggest partner)

FDI is an alternative to trade, and also spurs trade flows.

Europe more important for Asia than the US

- Outward FDI stocks ($m):
  - US: $6,361,419
  - EU: $7,977,584
  - Japan: $9,452,234
  - China: $1,357,390

- Inward FDI stocks ($m):
  - US: $6,555,622
  - EU: $2,755,147
  - Japan: $2,755,147
  - Korea: $1,357,390
  - Australia: $6,361,419
  - New Zealand: $6,361,419
  - Indonesia: $6,361,419
  - India: $6,361,419
Global FDI flows Asia (2012-2016) (Europe again)

FDI flows between Asia and Europe also bigger than for the US

Does the Trade war push Europe and Asia closer together?

Outward FDI flows ($m)

Inward FDI flows ($m)
Europe – Asia: Need each other

**EU selling points**
- Hi-tech
- High-end / luxury
- Quality / style

**Problems**
- Low growth
- High unemployment
- High wages / low wages growth
- Low productivity
- Can’t fill US Agri shortfall

**Asia selling points**
- High growth
- High productivity
- Lower wages / higher wages growth

**Problems**
- Need for high tech
- Needs US agriculture imports
Cars – important for the US
Cars are central to US trade woes

- US imports 3.5m cars per year (20% of total US sales of 17.5m light vehicles). Of those, around 2.7m (77%) come from Asia, mainly Japan and Korea.

- Asian car manufacturers also produce around 3.4m cars in the US. Many of these are then exported from the US to other countries.

- About 313,000 Americans are employed in the automotive production. Of these, some 82,000 are employed in Asian firms.

- Toyota produces 1.3m cars in the US each year.
- Honda produces 1.2m cars.
- Nissan about 0.9m.
- Hyundai / Kia about 0.7m cars.

- Some Asian cars are more “American” than US brands – considering the % of their parts.

- The ~$190bn deficit in the automotive sector is about 1% of US GDP, accounting for about 1/4th of the total 4% manufacturing trade deficit.
Beijing car tally

• A 5 min window of a journey I took in May 2018 from Beijing Pudon airport to the Grand Hyatt Beijing

• With the exception of Ford, and 1 Cadillac, the car pool in China is largely European, with some Japanese and local.

• Is this protectionism – or do Chinese households just prefer European cars?
Unit price of imported cars – EU vs US

It isn't price that is driving the gap between US and European car sales – the unit price is virtually the same.

But typically, US cars are cheaper than EU cars, so perhaps it is a question of “value for money”, or brand preference.

For the same price and same basic car type, would you buy US or EU (German)?

Source: Bloomberg
Trade-weighted FX – not many stand-outs

- Most Asian currencies appreciated in 2016 and 2017 on a trade-weighted basis, and have depreciated in 2018
- The Philippine peso and Indonesian rupiah stand out as exceptions on the downside (add also INR)
- Taiwan dollar and Thai baht appreciated more than the others (but not much).
Real currency valuations – mostly fair

- There are few stand-out misalignments in the Asian FX space
- China could appreciate some more without becoming overvalued
- Malaysia is becoming fair value or maybe now exceeding it...depends on start date
- Indonesia has declined, but not that much
- Philippines looks weak, Singapore steady, and
- Thailand remains strong
A more direct way to look at competitiveness, and room for CB policy changes is export growth. 2017 export strength was partly a function of 2016 weakness. ASEAN saw very robust export growth in 2017 – though there were helpful base effects. Even accounting for these, Malaysia still looks impressive. Singapore is hanging in, though rates of growth are fairly pedestrian. …Indonesia’s exports are no longer looking all that strong. China on the other hand had a USD export bounce in line with the decline in 2016, but has continued to push ahead. Taiwan and Korea are looking softer, after stellar 2017.
Inflation – a mixed bag

• North Asian inflation is stable, and in a Goldilocks range (1-2%) – allowing policymakers to focus on other targets (Hong Kong is a little high)

• Inflation in SE Asia falls into two camps
  1. Those for whom inflation is a bit high (Indonesia, Philippines, Vietnam) though typically inflation targets are also a bit higher
  2. And those for whom it is a bit low (Thailand, Singapore)
  3. Malaysia is in the midst of removing GST and replacing it with SST, so hard to say

Likely policy response varies across both groups
Real policy rates – how much policy leeway?

- Real rates for most of Asia are close to zero, and negative for some.
- Positive real rates (China, India, Indonesia, Malaysia) probably justified, could rise further
- Negative real rates (Japan, Philippines) have room to rise
• Some strong (sometimes too strong) contributions from domestic demand (PH, CH, MY, IN)
• Some poor (SG, TH, TW)
• And some middling (HK, KO) – suggests varying central bank responses
“USD: Making everyone (else) great again!”

“What we really think of the Bank of England’s rate decision”

“Normalisation will be a long, uncomfortable journey”

“G10 FX: Careless Central Bank Whispers”

“When caution’s not enough for the euro”

“What is it good for?”

“Some Brexit clarity at last?”

“Riding the cryptocoaster”

“Trade war: What is it good for?”

“Trump: The next 100 days”

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