Market Strategy

Essential Asia: Bear with us

A macro strategist's view on Asian economies and markets

National Australia Bank

25 January 2016

Talking points

- **The twin end-2015 falls in the price of crude oil and the RMB against the USD contributed to a sharp spike in risk aversion that hit all of EM, Asia included.**
- **Policy flip-flops in China compounded the problem and have yet to be fully resolved, although we believe that the authorities will find their feet eventually.**
- **While comments coming out of the WEF in Davos and elsewhere have calmed the markets somewhat, the reasons for the initial panic still remain and it might be premature to call a near term end to the risk-off mood.**

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Recent reports

- Chinese Economic Briefing, 19 January 2016
- Asia Dashboard, 4 January 2016
- 10 Themes for 2016, 23 December 2015

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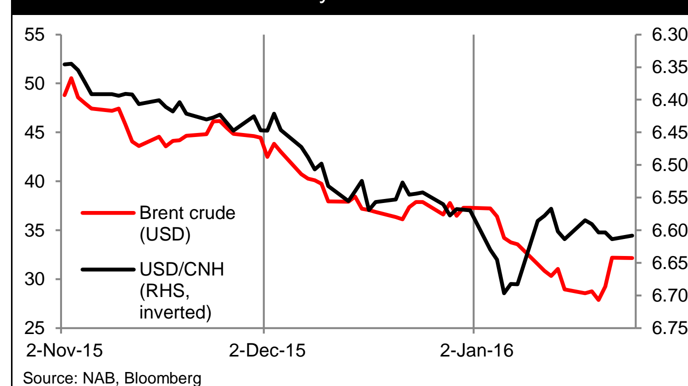
Trade recommendation

Entry Date	Recommendation	Opening level	Target	Stop
4 Jan	Long USD/KRW (6M)	1186.4	1250	1148
4 Jan	Long USD/SGD (6M)	1.4307	1.47	1.3955

Chart of the month – January 2016's twin terrors



Source: NAB, Bloomberg

Policy Rates

	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Korea	1.75	1.50	1.50	1.50	1.50	1.75	1.75	2.00	2.25
Thailand	1.75	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00
Malaysia	3.25	3.25	3.25	3.25	3.50	3.75	3.75	3.75	3.75
India	7.50	7.25	6.75	6.75	6.75	6.75	6.50	6.25	6.25
Indonesia	7.50	7.50	7.50	7.50	7.25	7.25	7.00	7.00	6.75
China	5.35	4.85	4.60	4.35	4.10	3.85	3.85	3.85	3.60

Asian FX Forecasts

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
USD/CNY	6.60	6.70	6.75	6.80	6.80	6.75	6.75	6.70
USD/IDR	13800	14000	14000	14100	14500	14500	14500	14500
USD/INR	67.0	66.5	66.5	66.0	66.0	65.5	65.0	64.0
USD/KRW	1220	1250	1250	1250	1200	1200	1180	1150
USD/MYR	4.30	4.30	4.35	4.40	4.40	4.40	4.38	4.35
USD/PHP	48.0	49.0	47.5	48.0	48.0	47.5	47.0	46.5
USD/SGD	1.44	1.45	1.47	1.48	1.47	1.46	1.45	1.45
USD/THB	36.5	37.0	37.5	38.0	37.5	37.5	37.5	37.5
USD/TWD	33.5	34.0	34.5	34.8	35.0	35.0	34.8	34.5

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
AUD/CNY	4.42	4.42	4.59	4.69	4.69	4.73	4.86	4.89
AUD/IDR	9246	9240	9520	9729	10005	10150	10440	10585
AUD/INR	44.9	43.9	45.2	45.5	45.5	45.9	46.8	46.7
AUD/KRW	817	825	850	863	828	840	850	840
AUD/MYR	2.88	2.84	2.96	3.04	3.04	3.08	3.15	3.18
AUD/PHP	32.2	32.3	32.3	33.1	33.1	33.3	33.8	33.9
AUD/SGD	0.96	0.96	1.00	1.02	1.01	1.02	1.04	1.06
AUD/THB	24.46	24.42	25.50	26.22	25.88	26.25	27.00	27.38
AUD/TWD	22.45	22.44	23.46	24.01	24.15	24.50	25.06	25.19

Nothing to fear but fear itself

- **The twin end-2015 falls in the price of crude oil and the RMB against the USD contributed to a sharp spike in risk aversion that hit all of EM, Asia included.**
- **Policy flip-flops in China compounded the problem and have yet to be fully resolved, although we believe that the authorities will find their feet eventually.**
- **While comments coming out of the WEF in Davos and elsewhere have calmed the markets somewhat, the reasons for the initial panic still remain and it might be premature to call a near term end to the risk-off mood.**

The uneasy calm might not endure

The first 14 trading days of 2016 were fairly brutal for global markets all round as risk aversion took hold in a big way, largely predicated on weakness in both oil and China. While comments from various parties in Davos and elsewhere helped to create a relief rally of sorts, it might be a bit premature to call for a full reversal in risk sentiment given that many of the fundamental underpinnings for the two key areas of weakness remain.

Nevertheless the reform process in China still looks orderly and under control, and the weakness in oil still looks to us to be very much an oversupply issue and not the early signs of flagging economic growth. The market at large might need more time to be convinced of these so in the interim, more weakness and more volatility cannot be ruled out.

China’s contribution goes both ways

Undoubtedly, China contributed materially to the loss of confidence towards the end of 2015 that ultimately led to the recent carnage. In the immediate aftermath of the RMB attaining reserve currency status upon admission to the IMF’s Special Drawing Rights (SDR) basket on 30 November 2015, the PBoC seemed to let the market have much more say in determining the daily fixing. This saw the USD/CNY fixing rise strongly and the USD/CNH premium widen sharply, in turn exacerbating the demand for outflows and also the spill-over onto the Shanghai stock market. After various policy fumbles, the authorities seem to have settled on heavy intervention in the stock market and a suspension of the USD/CNY fixing mechanism as an interim “emergency mode” to calm markets down.

While the Chinese delegation to Davos seems to have done a pretty decent job of helping to mollify the markets, this calm might not prove to be all that enduring. The officials struck a dual-track tone, vowing that China will honor its commitments to the IMF on RMB liberalization, but also vowing to “take care of investors” in the stock market. This corroborates our expectation that the authorities intend for the inexplicably stable USD/CNY fixing to be transitory and should reassure markets that the authorities intend to return to the path of liberalization and reforms. On the stock market though, the stance seems to be a little out-of-date but perhaps the authorities only have a high enough pain threshold for volatility in only one asset class at a time and FX currently takes priority.

Oil and the slippery slope

The December OPEC decision to not cut production, against the backdrop of the imminent return of Iranian supply and first exports of US crude sent oil prices sliding fast in December and to below US$30/bbl in January. Various narratives speculating that this might reflect weakening global demand, or might spark acute deflation, seemed to gain traction and contributed further to the loss of confidence.

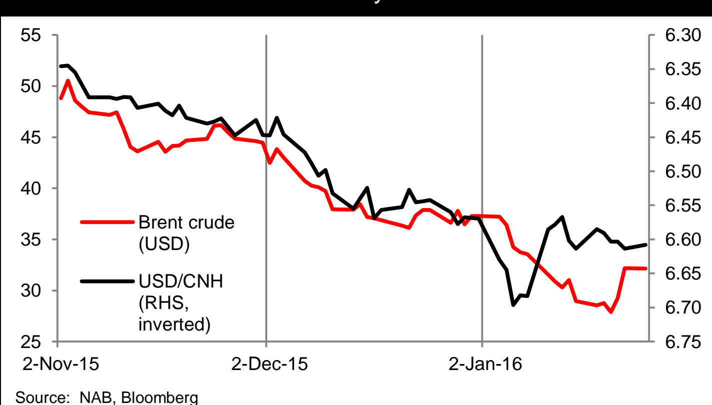
While it must be emphasised that the oversupply situation still remains and will likely take some months to clear up, it does appear that the pre-Davos market price action had seen some amount of overshooting. Jawboning at Davos by the chairman of the Saudi state oil company will likely keep the oil price above US$30/bbl for the near term, but it might also prove sticky on the upside.

Just how dead is this cat?

Given the likely infusion of a significant amount of fear and relief in recent market movements, it is hard to say how far in either direction the bounce can go. Nevertheless, it has to be remembered that the fundamentals still favour a strong USD/Asia, especially from the immediate post-Davos levels. The USD/CNY is likely to soon be allowed to re-embark on its upward hike, and this will have a spillover onto other pairs like the USD/KRW and USD/SGD.

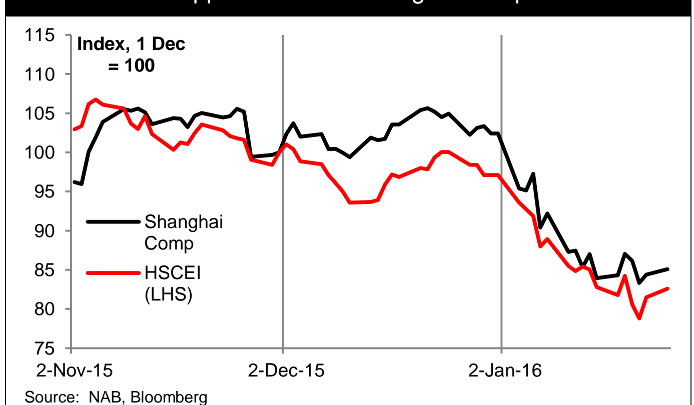
The USD/TWD meanwhile will also be supported by China’s edgy response to Taiwan’s second president from the pro-Independence Democratic Progressive Party. New president-elect Tsai Ing-wen though seems to be very much a moderate and the jitters will probably fade away quietly.

Chart 1: The twin terrors of January



Source: NAB, Bloomberg

Chart 2: State support cushions Shanghai Comp’s fall



Source: NAB, Bloomberg

China Spotlight: No monkeying around

- **The upward adjustment in the USD/CNY fixing in early December sparked a sharp climb in the USD/CNH and a sharp widening of the premium.**
- **That in turn sparked a sell-off in the Shanghai Composite and followed by some confusion on the part of the authorities.**
- **The events of December and January 2016 have introduced an increased level of doubt over the Chinese authorities' ability to manage an orderly reform path.**
- **While the authorities are still likely to find their feet, the return to the path of reforms might be a bit bumpy and could extend till after the Lunar New Year.**

Pushing past the pain

The major take-aways from the events of December 2015 and January 2016 seems to be that the authorities do have a finite pain threshold and that was hit on 8 January, when the PBoC began to keep the USD/CNY fixing flat in the vicinity of 5.560. While the authorities do seem to have left hints that this is a temporary FX regime, it remains to be seen how much time is needed for them come to terms with the fact that liberalization inevitability entails spikes in volatility in both the equities and FX markets. Chinese officials at the World Economic Forum in Davos have however, reiterated China's commitment to continue to liberalize the management of the RMB.

What appears to have triggered the authorities to suspend the USD/CNY fixing mechanism introduced in August, is an 18% drop in the Shanghai Composite over the span of three weeks. During that time, the circuit breaker in the A-shares market, introduced in mid-2015, was triggered twice in consecutive days and the authorities finally removed it. Subsequent organized intervention (to purchase stocks) by various quasi-government agencies failed to stem the selling in A-shares and the apparent suspension of the USD/CNY fixing mechanism seems to be a an attempt to break any feedback loop between the FX market and the A-shares market.

The disruptive impact on liquidity from the upcoming Lunar New Year holidays might give the authorities sufficient license to postpone a return to the August mechanism, but the authorities have signalled that they intend to let the "fundamentals" determine cross-border capital flows. The need to uphold their agreement with the IMF over currency liberalization, and the recent move to manage the RMB against a basket of currencies suggest that there is no entrenched intention to return to "pegging" the RMB to the USD.

Gradual slowdown still the central scenario

Q4 GDP slowed to 6.8% yoy and 1.6% sa qoq, from 6.9% and 1.8% respectively in 3Q. Full year 2015 growth was 6.9%, broadly in line with market expectations and with the government's 7% target. Sectorally, the financial turmoil has hit financial intermediation, which slowed to 12.9% yoy growth in 4Q from 16.1% yoy in 3Q and 19.2% in 2Q. Helping to cushion that slowdown was an acceleration in construction to 7.3% yoy in 4Q from 5.8% in 3Q. This perhaps reflects some increase in fiscal spending on infrastructure.

Also hinting at targeted spending is the divergence in the growth rate in overall fixed asset investment (FAI) versus infrastructure-related FAI. The latter – 15% of total and consisting of FAI in railways, highways, information technology, water conservancy, and health care – continues to grow at close to 20% yoy compared to around 10% for overall FAI.

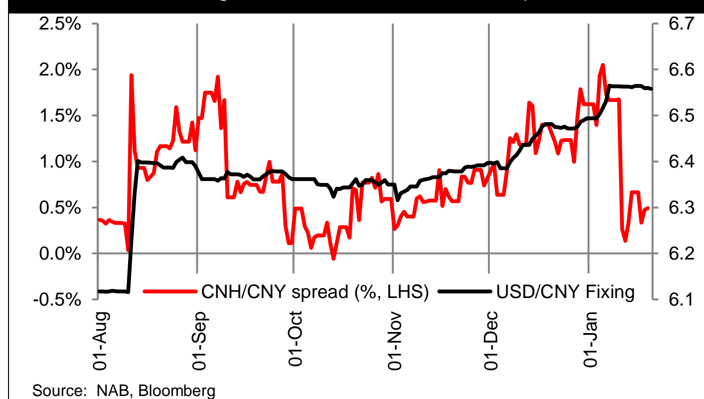
The other two key pieces of economic data were in line with the picture of gradual deceleration in growth. Industrial production slowed to 5.9% yoy in December from 6.2% in November, while retail sales slowed marginally to 11.1% yoy from 11.2%.

RMB still likely to depreciate gradually

While it is difficult to say exactly how long the PBoC will keep the CNY on a tight leash and the fixing static, there are enough reasons to believe that the authorities will return to the medium term path of a more liberalized FX management regime. With the demand to take money out of China still appearing to be fairly intact, it is more than likely that this return to a more market-determined USD/CNY will also mean that the pair is likely to biased upwards for the next few months.

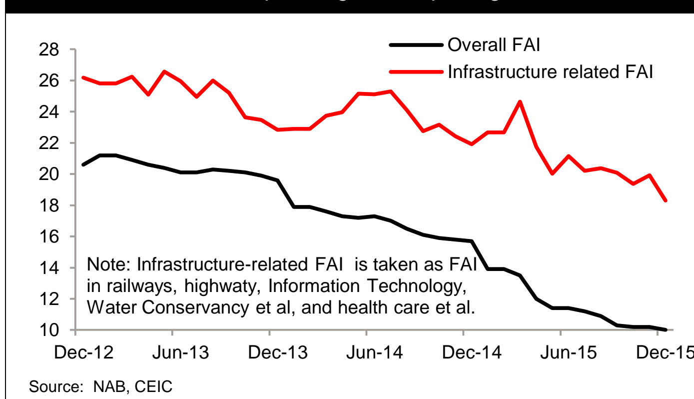
An outlook of a gradually rising USD/CNY therefore, still seems to be the most reasonable projection and we expect the pair to end the year at around 6.80.

Chart 3: Static fixing coincides with CNH-CNY spread decline



Source: NAB, Bloomberg

Chart 4: Infrastructure spending still outpacing overall FAI



Source: NAB, CEIC

Korea Spotlight: BoK on the fence

- **USD/KRW had been on a one-way track up but the USD/JPY's drop and the USD/CNY's stall in January have put the brakes on that.**
- **Strong household borrowing, robust inflation, a weakening currency, and US rate hikes all lean towards potential hikes by the Bank of Korea in the near future.**
- **We maintain our long USD/KRW position targeting 1250 in June 2016, as the USD/CNY looks set to head still higher in the months ahead.**

Staying the course

Despite the chaos and uncertainty in Korea's larger neighbour to the west, the picture for Korea and the KRW remains fairly stable and clear: the confluence of pressures still indicate that the Won will likely weaken over the medium term. The main driver remains the pressure for the USD/CNY to head higher over the course of 2016.

In the near term, the USD/JPY's sharp tumble and the stalling of the USD/CNY's upward trek have seen the USD/KRW retrace downwards a little but this is not likely to prove too enduring.

This gradual weakening in the currency is not likely to be too disruptive given that domestic growth engines remain quite resilient and domestic corporations should be able to adjust quite comfortably. Since the Asian Financial Crisis in the late 1990s, Korea has kept its short-term external debt levels fairly low.

Growth remains healthy

Expectations for Korea's GDP growth for 2016 remain at a fairly healthy 3%. Indeed, the Bank of Korea in its latest monetary policy statement elaborating on its January decision to keep rates unchanged, stated that domestic demand, especially consumption, continues to recover strongly. Employment also continues to grow, especially in the domestic-oriented sectors.

Additionally, inflation appears to be stubbornly resilient, even if headline inflation remains, at 1.3% yoy, substantially below the BoK's 2% inflation target – core inflation edged upwards to 2.4% yoy in December. The central bank also flagged an unsustainable rate of growth in household borrowing, especially mortgage borrowing, as a key concern.

Alongside these two factors, the BoK also mentioned US monetary policy, financial conditions in China, and capital flows. Apart from China, it might be argued that the outlook for US policy and the risk of capital flight are supportive of rate hikes in tandem with the US. The tone of the latest monetary policy statement seems to suggest that the BoK has moved to a fairly neutral stance on rates and are mulling the need to get even more hawkish.

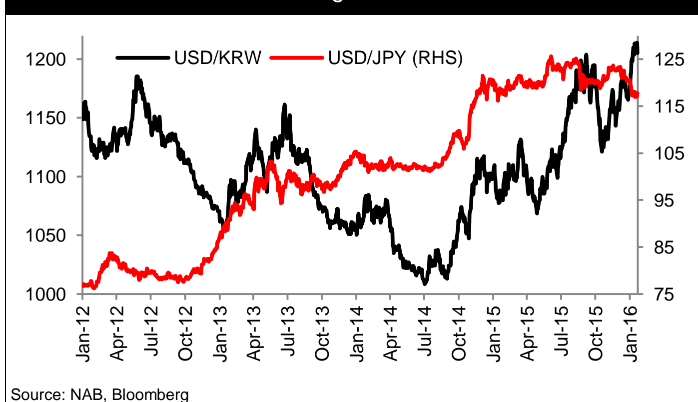
Short term external debt not a problem

Currency depreciation has sometimes been feared as a potential cause of disruptions to local corporations on the back of concerns about potential difficulties with servicing short term external debts. Indeed this was a problem during the Asian Financial Crisis but since then, external liabilities have been better managed. As of 3Q 2015, total short-term external liabilities (maturing in 12 months or less) accounted for just 8.6% of GDP or 33.4% of FX reserves.

Won depreciation still on track

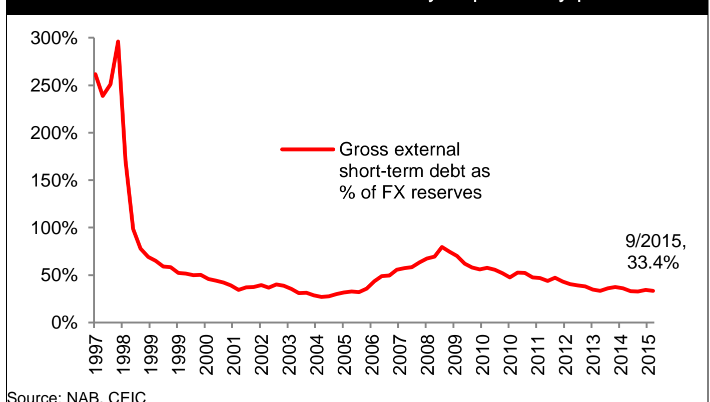
Given that full year 2015 exports were down 8%, the authorities will probably be quite comfortable with a depreciation in the KRW against both the JPY and the CNY. While the USD/JPY might stay around current levels for a while if risk aversion continues, the USD/CNY rate should resume its upward trek soon enough. It is unlikely that the Chinese authorities will risk their newfound international credibility by reverting back to a pegged USD/CNY.
Any upward move in the USD/JPY will add upward pressure to USD/KRW.

Chart 5: USD/JPY fall has weighed on USD/KRW



Source: NAB, Bloomberg

Chart 6: Short term debt levels not likely to pose any problem



Source: NAB, CEIC

India Spotlight:
INR: See you later!

- **The INR has remained fairly stable against the backdrop of a more volatile North Asia.**
- **Growth momentum looks set to remain strong, despite a December dip in industrial production.**
- **If early passage of reforms like the GST in April 2016 starts to look likely, increased portfolio inflows could be induced.**

INR to ride the volatility

As we noted in December's Essential Asia, India's growth and inflation outlooks are the most positive in Asia. These and the high carry on the INR, probably contributed to the USD/INR remaining fairly stable despite the turmoil in financial markets, along with some intervention from the RBI. The INR continues to look set to outperform most of its Asian counterparts.

As the markets continue to be roiled, in large part by the uncertainties surrounding China, Indian markets will also benefit from the economy's relatively autarkic state, especially with respect to trade links with China. Additionally, India is also seen as possessing a greater capacity to productively absorb investment, as seen by Japan's interest.

Growth looks fine but inflation stubbornly resilient

So far, the growth side appears to still be on track but inflation looks to be less cooperative. Despite November's dip in industrial production overall and that of both capital goods and consumer durables, the multi-month trend in both of these is still positive and general sentiment indicators still suggest that the domestic growth drivers are strong.

Inflation though looks like it could be somewhat sticky on the downside, with core inflation creeping up a little over the last few months. Headline CPI inflation also crept up from 5.4% yoy in November to 5.6% yoy in December. A continued moderation in inflation would be crucial to providing room for the INR to appreciate on trade-weighted terms without losing too much in terms of competitiveness. This though should not be ruled out if the RBI does indeed hold off on rate cuts in H1.

Yield curve could steepen

As the market continues to price in the improving growth outlook, the yield curve could start to steepen in earnest. Already, the 10yr-2yr spread has begun to widen, with the 10yr yield doing most of the work there. The improving growth outlook is probably the easier one to price in, given that the data has been trending in that direction for some time now.

The outlook on interest rates though is in a bit of a state of limbo right now, with the relatively high interest rate and relatively low and stable inflation leaving the RBI more room for further cuts this year – indeed NAB is expecting another 50bps worth of cuts in 2016. On the other hand, there are caveats to that view in the shorter term: US rate hikes, bottoming core inflation, and the RBI's hints about not cutting anymore in the near term.

In short, near term steepening should be driven more by rising longer-dated yields while falling short-dated yields could start to drive the steepening towards the middle of the year. Money moving out of longer-dated bonds though might well still stay in India, most likely moving to equities.

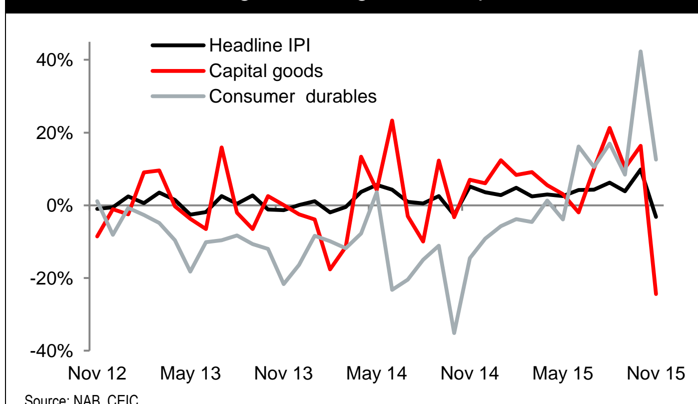
That elusive GST bill

The posturing continues between the government and the opposition, with both sides claiming obstructionism by the other. The key cut-off is the April passage of the 2016 budget, although if the GST bill passed shortly after, the benefits might still feed through into expenditure plans. It is estimated that the GST will generate around USD 15 billion a year via a boost to growth from the harmonization of the tax structure. For now, there is still a good chance that the GST bill could still contribute to the 2016 budget.

Risk-off environment dragging the INR along

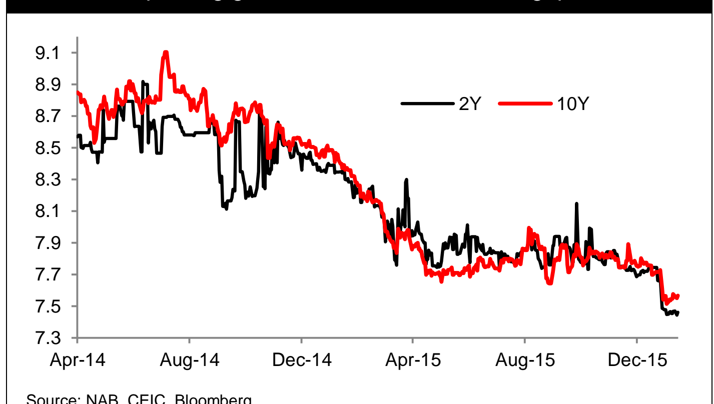
While India's fundamentals remain positive, the fall-off in risk appetite in the markets has hurt Emerging Market currencies and assets hard – and the INR has not been able to buck the trend. While losses in the INR have been fairly muted, it does appear likely that the central bank has been in the market to contain volatility. Our short USD/INR trade has been stopped out but we will look for a better time, and probably a better level, to re-enter that trade.

Chart 9: Domestic engines strong till Nov blip



Source: NAB, CEIC

Chart 10: Improving growth outlook widens 10-2 gap



Source: NAB, CEIC, Bloomberg

Singapore Spotlight: Economic adjustment continues

- **Advanced estimate for Q4 GDP came in surprisingly strong with construction and services both looking fairly healthy.**
- **The SGD remains quite tethered to the CNY and susceptible to the general risk-off sentiment.**
- **The SGD NEER has drifted near to the floor of the band but an April flattening of the policy band slope is not a sure thing yet.**

Economy still robust but external chaos dominates

The SGD continues to be tethered to the chaos emanating out China and has weakened despite a fairly strong Q4 GDP number. The SGD is likely to remain a key proxy for the wider market's sentiment towards Emerging Asia, particularly China.

The recent simultaneous weakness in the CNY alongside strength in the EUR and JPY, has taken the SGD NEER closer to the floor of the policy basket but it is not likely that the authorities will be easily spooked, especially with growth looking strong and core inflation still looking like it's bottoming.

Table 1: Economy stabilizing but still fragile

	IP	Core CPI	PMI	NODX
Actual	-5.5%	0.2%	49.5	-3.3%
BBG consensus	-3.0%	0.4%	N/A	1.5%
Previous	-5.4%	03%	49.2	-0.5%

Economic restructuring still ongoing

As the growth trend in the three major industrial segments illustrate quite clearly, manufacturing is continuing on its long walk into the sunset even as services continues to hum along. The growth spurt in construction is probably a reflection of the fiscal spending on infrastructure (mainly mass transit) and the growth rate could taper off later in 2016, unless the government decides to run another year of deficit spending.

With the turmoil in the financial services and risk aversion hurting Emerging Markets, including Asia, financial services – which has been amongst the frontrunners in the services segment of the economy – could suffer somewhat and lower the rate of growth in Q1 2016. This might not necessarily translate into significant loosening, given the economy seems to already be running at close to capacity.

This continued gradual shift towards services also shifts the dynamics of the management of SGD policy away from prioritizing price adjustment in favor of a regime that abets the new growth sectors. Services tends to benefit more from stability in the currency, especially financial services.

S$NEER slides on EUR and JPY strength

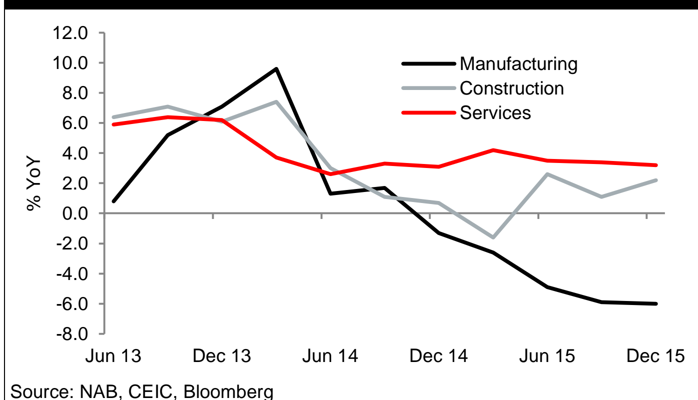
The appreciation of the USD, EUR and JPY since the middle of December has served to significantly weaken the SGD NEER. Additionally, the increasingly risk-off environment saw the SGD also weaken against some key Asian counterparts like the CNY and the THB, which also contributed to lowering the NEER.

Over the next few weeks, the amount of adjustment in the majors could be less severe and any improvement in the market risk appetite should see the SGD NEER stabilize somewhat, around 1.7% below the mid-point. This doesn't leave a lot of downside room but the authorities have shown a willingness to let the NEER grind against the floor of the band before adjusting the policy band, especially if it pertains to an inter-meeting adjustment.

USD/SGD upside is likely to persist going forward, albeit in fits and starts, largely in line with the USD/CNY. The SGD though will probably roughly keep pace with most of its other Asian counterparts so the decline in the NEER going forward should be more gradual.

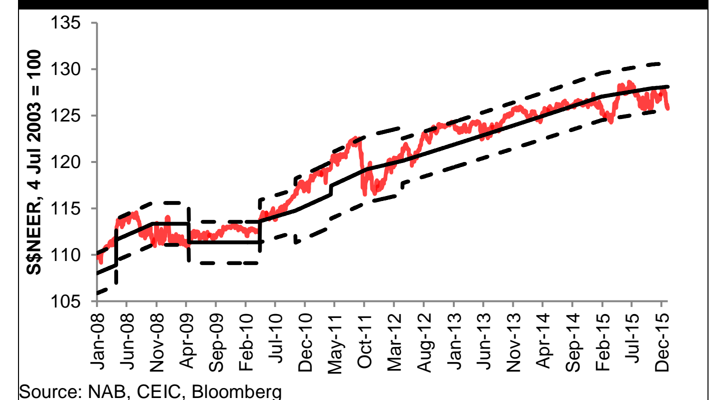
Nevertheless, should the S$NEER get close to the floor of the band around the time of the twice yearly MAS policy meeting, it is possible that the decision could turn out to be another "slight" reduction to the upward slope of the policy band.

Chart 12: Services and construction boosting GDP



Source: NAB, CEIC, Bloomberg

Chart 13: S$NEER nearing bottom of band



Source: NAB, CEIC, Bloomberg

Selected Indicators

Table 1: NAB Key FX Forecasts

		Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Australian Dollar	AUD/USD	0.70	0.67	0.66	0.68	0.69	0.69	0.70
New Zealand Dollar	NZD/USD	0.62	0.62	0.60	0.61	0.61	0.61	0.62
Japanese yen	USD/JPY	121	115	116	118	121	123	124
Euro	EUR/USD	1.06	1.09	1.07	1.06	1.07	1.07	1.08
British Pound	GBP/USD	1.52	1.42	1.39	1.36	1.39	1.39	1.42
Swiss Franc	USD/CHF	0.97	1.00	1.02	1.05	1.07	1.06	1.06
Canadian Dollar	USD/CAD	1.40	1.47	1.47	1.46	1.46	1.44	1.43
Chinese New Yuan	USD/CNY	6.40	6.60	6.70	6.75	6.80	6.80	6.75

Table 2: NAB Asia Macro Forecasts

Average annual growth in GDP (%)				
	2013	2014	2015	2016
Hong Kong	3.1	2.5	2.4	2.6
Indonesia	5.6	5.0	4.6	4.5
Singapore	4.4	2.9	2.2	3.3
Taiwan	2.2	3.8	2.1	2.8
Thailand	2.8	0.9	2.9	3.8
Malaysia	4.7	6.0	6.7	4.9
S Korea	2.9	3.3	2.2	2.5
Philippines	7.1	6.1	5.4	5.7
Total	**4.2**	**4.0**	**3.6**	**3.8**

Table 3: NAB Key Macro Forecasts

Global growth forecasts % change yoy							
Country/region	2011	2012	2013	2014	2015	2016	2017
United States	1.6	2.2	1.5	2.4	2.5	2.4	2.3
Japan	-0.4	1.7	1.6	-0.1	0.6	1.1	0.9
Euro-zone	1.7	-0.8	-0.2	0.9	1.4	1.7	1.9
United Kingdom	2.0	1.2	2.2	2.9	2.4	2.3	2.2
Emerging Asia	4.4	4.6	4.2	4.0	3.7	3.8	4.1
Latin America	4.9	2.5	2.6	0.9	-0.2	1.1	1.6
China	9.3	7.8	7.7	7.3	6.9	6.7	6.5
Canada	3.0	1.9	2.0	2.4	1.0	1.7	1.8
Australia	2.7	3.5	2.0	2.6	2.4	2.7	3.0
New Zealand	1.8	2.4	2.3	3.3	2.2	1.8	2.0
India	7.9	4.9	6.4	7.1	7.5	7.6	7.4
Africa	5.4	4.4	5.2	5.0	3.8	4.3	4.0
Eastern Europe	5.4	1.4	2.9	2.8	3.0	2.9	2.6
Middle East	3.9	4.8	2.4	2.7	2.7	2.5	2.5
Other advanced	3.3	2.0	2.2	2.8	2.3	2.4	2.6
World	4.39	3.38	3.27	3.30	2.99	3.18	3.32

Source all tables: National Australia Bank

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