29 February 2016

Essential Asia

National Australia Bank

In this issue

The Monkey's First Leap

Talking Points

- The monkey's first leap in twelve years brought about more market volatility.
- The BoJ's surprise introduction of negative interest rates in late January saw Japan become the latest target for the market's constantly evolving list of bogeymen.
- Continued discussion of a 'Brexit' added to market jitters fuelled by China and oil.
- While we acknowledge this in our forecasts for the FX Majors, we are maintaining our Asian currencies forecasts. We think Asian currencies are likely to still be tethered to the RMB, which is still likely to be subject to the authorities' allowing of corporate outflows to dominate.

Recent Reports

- 29 Feb 2016 – Global FX Strategist
- 22 Feb 2016 – US Economic Update: Fed funds rate
- 4 Feb 2016 – China Economic Update: China's risk levels have risen

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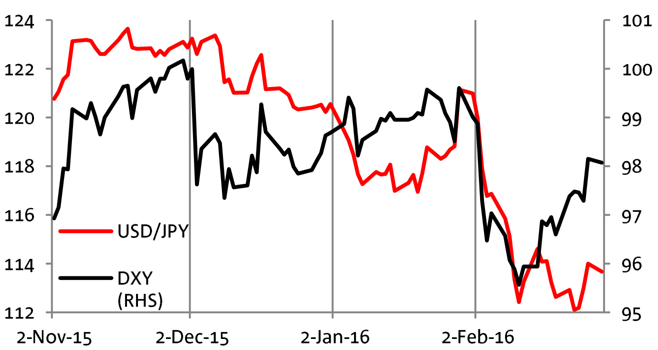
Chart of the month



Source: NAB, Bloomberg

Policy Rates (%)

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Korea	1.50	1.50	1.75	2.00	2.00
Thailand	1.50	1.50	1.50	1.75	2.00
Malaysia	3.25	3.25	3.50	3.75	3.75
India	6.75	6.50	6.25	6.25	6.25
Indonesia	7.00	7.00	7.00	7.00	6.75
China	4.10	3.85	3.85	3.85	3.60

Source: National Australia Bank

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Fear remains the monkey on the market's back

- **The BoJ's surprise introduction of negative interest rates in late January saw Japan become the latest target for the market's constantly evolving list of bogeymen**
- **The surprise move sparked doubts over Abenomics, leading to a broad weakening of the USD and an overall risk-off stance in the markets. Continued discussion of a 'Brexit' will contribute to market jitters**
- **With the data continuing to be inconclusive, the risk sentiment could oscillate quite aggressively for some time, with USD-strength likely held in abeyance for the time being**
- **While we acknowledge this in our forecasts for the FX Majors, Asian currencies are likely to still be tethered to the RMB, which is still likely to be subject to the authorities' allowing of corporate outflows to dominate**

While we are mindful of the projections of reduced USD-strength against the major currencies through the course of 2016, we have decided to maintain our USD/CNY forecasts. The main rationale is that this reflects China's policy preference for continued liberalisation of the RMB, which will mean that corporate outflows will be allowed to dominate the balance of payments. The secondary benefit of a growth-supportive currency will probably be deemed to be useful.

China appears to be committed to continuing its monetary easing via rate cuts in addition to targeted fiscal measures. A weakening of the CNY in a gradual and orderly manner will be a complementary to this policy landscape. A global environment of reduced USD strength is not expected to move China from this path given that it would be the natural outcome of continued liberalisation in an environment of heightened corporate outflows.

Reduced USD strength overall and the authorities' intent to keep the RMB stable against a basket of currencies will mean that the RMB will have to remain at a weaker level relative to the other currencies in the basket, mostly the EUR and JPY.

We may be more inclined to raise our forecasts for other Asian currencies vs the USD, but prefer to wait for a more stable risk environment within the global FX markets.

Evolving AUD/CNY dynamics

One currency that might enjoy increased strength against the CNY is the AUD. Further interest rate cuts in China will narrow the interest rate differential in favour of the AUD. Increased fiscal spending on transport-related infrastructure will also benefit the AUD via higher prices in hard commodity prices – iron ore prices have recently found some joy and China's talking up the need for targeted fiscal spending in selected infrastructure projects could prove supportive. One other avenue is the increased tourism earnings in Australia, not least of all from Chinese travellers – November 2015 saw tourists from China surge past the 1 million mark.

Stability in the oil price favours MYR and IDR

The two currencies of the only significant oil exporters in EM Asia should benefit from increased stability in the price of oil. Although this might yet prove fleeting, it appears that there is some consensus amongst a few major oil exporters that the time has come for some concerted action. While forging an actual agreement could still prove tricky, especially with new market entrant Iran trying to establish a foothold in the market.

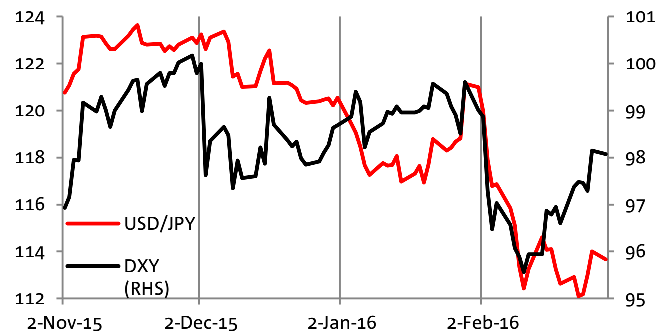
The MYR though could be stymied by domestic political uncertainty emanating from the investigations into financial irregularities at a state investment firm.

"Clarity" on the RMB regime

Calls for China to provide greater clarity on what their plans are for the RMB regime seems to have been partially heeded. PBoC Governor Zhou Xiaochuan reiterated that there was no need for sustained RMB depreciation and that the RMB would be kept stable relative to a basket of currencies, presumably the CFETS RMB Index.

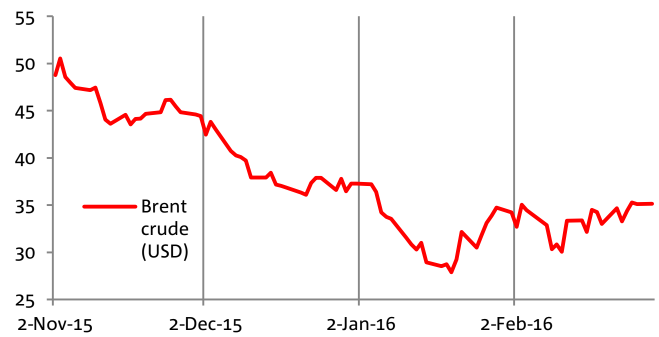
The market though will need some concrete action to convince it though. One way might be for the PBoC to consistently keep the USD/CNY fixing near the previous day's close, a mechanism that been introduced in August 2015. A return to the reform path would provide some comfort to a market that had seen the authorities in China appear panicked and flustered by market volatility. That the authorities tolerated a 6.4% drop in the Shanghai Composite in the run up to the G20 is an encouraging start.

Chart 1: USD/JPY has not recovered unlike the USD index



Source: NAB, Bloomberg

Chart 2: Oil found some stability in Feb



Source: NAB, Bloomberg

China Spotlight:
The slow winter thaw continues

- **A calmer CNY precedes some gradual weakening**
- **Fiscal and monetary policy tools are broadened, but still very measured and prudent**

The CNY calms down

USD/CNY stabilised around 6.52 after the week-long Lunar New Year holidays, but not before pivoting around 6.58 for most of January and early February. The CFETS RMB trade weighted index staged a modest bounce from the lows of 98.8 to 99.3, but lost steam soon after. We think the policy intent to maintain a stable currency will endure even after the G20 Finance Ministers and Central Bank Governors' meetings in Shanghai.

Measured measures

The Chinese authorities got down to business almost immediately after the holidays. First, the government announced that it plans to double its infrastructure bond program from RMB300bn to RMB600bn (or more) per year. This should not be seen as a panic move nor an abandonment of its targeted stimulus. This focused investment spending has been evident since Q4 2013, when the growth rate in FAI started to slide from just above 20% yoy to 10% as of December 2015. Over the same period, a subset of that – railways, highways, information technology, the environment and health care – amounting to 15% of the total, slowed from around 25% yoy to 18.3%.

In an effort to further inject more liquidity into the onshore bond markets and encourage its growth, the authorities have announced that qualified foreign institutional investors will be allowed to participate in the onshore interbank bond market. This is undoubtedly a move forward for domestic financial markets.

Maintaining a balance in NPLs too

The Chinese authorities had reportedly decided on a reduction in the minimum NPL coverage ratio of 150% to 120%. This seems largely symbolic given that the commercial banking sector overall has provisions of around 180% of current NPLs; large commercial banks have provisions of around 170%. This was further augmented by potential allowance for domestic banks to issue up to CNY50bn of asset backed securities based on their NPLs. Nevertheless, a reduction in the mandated minimum provisions level though would signal that the government is quite confident about the assessment criteria for NPLs. Given the government's willingness to bear with the pain of reforms over the last five years, it is quite unlikely that this is merely an exercise in expedience.

Shifting the controls

Towards the attempt to further modernize the system of economic management, the PBoC appears to be shifting the use of its monetary policy tools away from quantitative options like the RRR towards more price-based tools, like the interest rate on the medium-term lending facility (MLF). Separately, newswires reported that the central bank has asked selected banks about their liquidity requirements through its MLF. The same sources also said the PBOC cut rates for six-month MLF loans by 15 basis points to 2.85 percent and by 25 basis points to 3 percent for one-year loans. Right after the media reports on MLF, the central bank issued RMB163bn worth of MLF to 20 financial institutions.

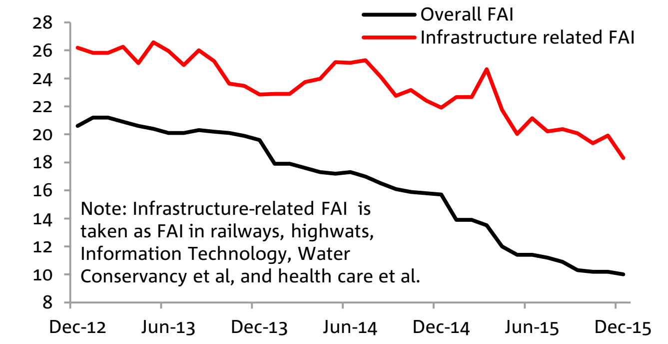
In recent weeks, central bank officials have also signalled a reluctance to rely on broad-based easing tools like cuts to RRR to support the economy, on concerns that these measures could weaken the CNY further and exacerbate the capital outflows situation.

Corporate flows favour firmer USD/CNY

Meanwhile, January Aggregate Financing spiked up to RMB3.42tn largely due to RMB2.54tn in new RMB loans. These numbers are undoubtedly large even on a seasonal basis and could reflect a combination of looser credit from the authorities and a shift in the borrowing mix by corporates. Additionally, other components like bond and equity financing, and entrust loans, all saw increases.

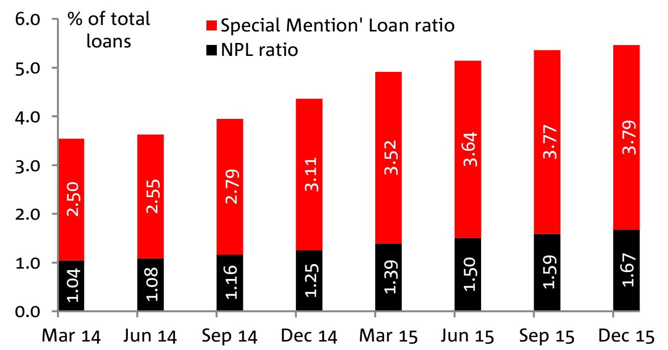
Over the six months from August 2015 to January 2016, foreign currency loans have seen a monthly fall of RMB141bn compared to a just RMB 5bn on average the previous 12 months. This signals the extent of corporate pre-payments and the stability in the USD/CNY probably belies the resilience of these outflows. Any significant depreciation in the CNY could spark another increase in outflows. The authorities have tightened their enforcement of capital controls over the months of January and February so they might be willing to test them out in the weeks ahead.

Chart 3: FAI skew towards infrastructure to be intensified



Source: NAB, CEIC

Chart 4: Rising NPL and Special Mention loan ratios



Source: NAB, CEIC

Korea Spotlight:
Drifting in line with China

- **Korea's economy continues to be supported by its domestic sector as exports remain sluggish**
- **The BoK looks to be in a neutral stance on rates, with the external weakness negating domestic strength**
- **The USD/KRW appears likely to take its cue from the USD/CNY and remain fairly buoyant despite the lower USD/JPY**

The economy remains rather resilient on the back of strong growth in private consumption (PCE) and investment (GFCF). The external sector continues to be weak, especially demand from China, and that should keep the KRW weak for a while.

The fall in the USD/JPY has not had the usual impact on the USD/KRW. Japan and Korea have historically been close third party competitors but this relationship seems to be breaking down, or has at least been suspended for now.

The Bank of Korea continues to remain quite comfortable with its current monetary policy stance, seeing the external growth risks negating the strength of domestic consumption and investment.

Domestic engines save the day

Q4 GDP grew a rather robust 3% yoy with PCE and GFCF growing 1.6% and 2.4% yoy respectively. On a sequential basis, the economy grew 2.3% qoq saar on the back of a 6.3% qoq saar growth in PCE. GFCF actually fell 1.6% qoq saar, but this is more likely just a temporary payback after three very strong previous quarters that saw an average of 11.2% qoq saar each.

Net exports for 2015 was down 18%, detracting from overall GDP growth (of 2.6%) by 1.3ppt. China's diminishing demand was a central reason for this and is likely to remain so as its slowdown drags on. This is likely to continue to keep the KRW weak even if the JPY enjoys an extended period of strength. Overall, the weaker current account balance and USD/CNY strength should dominate the USD/KRW direction.

Inflation remains benign but lending being watched

The BoK continues to see inflation remaining low due primarily to the price of oil remaining subdued. January's headline and core inflation both saw a sharp dip on account of the fading out of the impact of a cigarette price hike in January 2015. The former is likely to hover slightly below 1% yoy and the latter slightly below 2% yoy in months to come.

Where there was some concern from the BoK was in household lending, in particular mortgage lending. This is in line with the strong consumer sentiment but for now it does not seem to be a big enough concern for the BoK to step on the brakes and hike ahead of the US Federal Reserves.

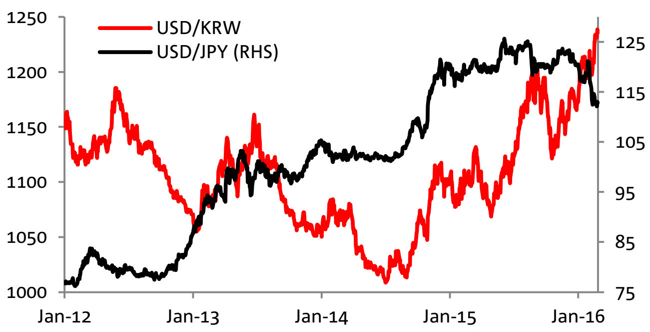
Remaining in China's orbit

Notwithstanding the slight reversal in the strong-USD story, the USD/CNY is still likely to remain buoyed by continued corporate and hot money flows in the months ahead.
It remains to be seen whether or not the Chinese authorities have been successful with their tightening of capital control measures. Either way however, there is still likely to be enough outflows to keep the USD/CNY supported.

Additionally, the slowdown in Chinese demand is also likely to persist as the authorities persevere with the culling of the weaker state owned enterprises (SOEs). Although the authorities have been stepping up the incentives to lend to erstwhile marginalized sectors like small and medium sized enterprises (SMEs), and agriculture, institutional inertia is likely to slow the pick-up in lending there.

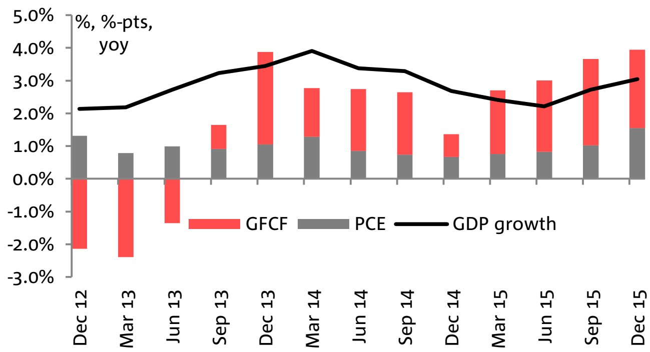
As such, the USD/KRW is also likely to continue on an upward trajectory in sympathy with the USD/CNY.

Chart 5: KRW has not followed the JPY's recent rise



Source: NAB, Bloomberg

Chart 6: Domestic engines still running quite strongly



Source: NAB, CEIC

India Spotlight: Maintaining the balance

- **4Q GDP grew an impressive 7.3% yoy led by private consumption, although investment slowed**
- **Inflation remains rather buoyant mainly on the back of food prices – rate cuts look unlikely in H1 2016**
- **The central bank is likely to continue to intervene on both sides to keep the USD/INR stable**

The Indian economy continued to chug along in Q4 2015 on the back of very robust private consumption. Investment growth slipped somewhat but rate cuts are not likely to be employed in the near term, although these are still likely later in the year, probably in H2.

Much attention will go to the budget session that's just beginning in parliament, especially on the progress (or lack thereof) in the legislation to introduce a Goods & Services Tax (GST).

The Reserve Bank of India (RBI) is likely to keep the USD/INR fairly stable to insulate the Indian economy from the external uncertainty to avoid spooking the domestic investment sentiment. Controlling inflation will remain the RBI's main priority; achieving this would allow the RBI to go on to cut interest rates and should also create room for the INR to appreciate on a trade-weighted basis without necessarily causing a loss in export competitiveness.

Consumption remains strong but investment flags

Q4's 7.3% yoy growth was fuelled by a strong rise in private consumption (PCE) that contributed 3.6%pts. Investment (GFCF) though only contributed 0.9%pt. The other components added 0.4-0.5%pt each, including net exports.

This slowdown in investment had already been flagged in the November and December growth rates of the production of capital goods, which fell sharply into negative territory. Nevertheless, the RBI's Industrial Outlook Survey still shows that overall outlook for Q1 and Q2 2016 was still positive, with both the Production and Order Books components both comfortably in positive territory.

Inflation remains stubbornly buoyant

CPI inflation ticked up to 5.7% yoy in January from 5.6% in December. Inflation in January, as has been the case for the previous three months, was mainly due to food inflation, which accelerated to 6.9% yoy in January. Strong sequential rises were seen from April to November 2015 but food prices have since flattened out. Base effects though will mean that the yoy number will remain elevated till April/May, which supports the outlook for any rate cuts to come only in H2 2016.

Cautious optimism on the 2016/17 budget

Market consensus is generally that the government will be able to meet its budget deficit target of 3.6% of GDP for the fiscal year ending March 2016. The government remains broadly committed to containing the deficit but also intends to increase infrastructure spending funded by asset sales and the GST, which is also supposed to improve the efficiency of collection and reduce compliance costs to the private sector.

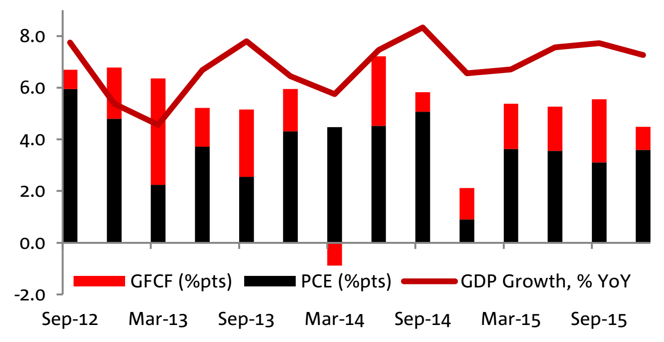
The market seems to be broadly optimistic on the prospects of a growth-supportive budget that's adequately funded. March will be a crucial month for Indian financial markets, which have been broadly sanguine on the prospects of the Modi government getting its way.

RBI to maintain equipoise

The central bank has thus far been able to keep the USD/INR fairly stable without expending much of its reserves.

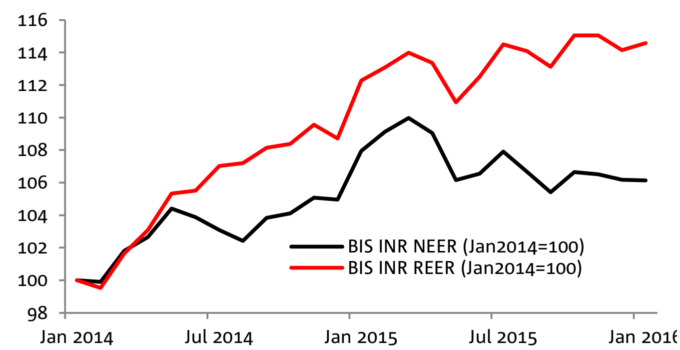
On interest rates, the RBI will want to assess the potential inflation impact of the budget before deciding how to proceed. This, and the timing of the base effects from food inflation both point to a cut in H2 at the earliest. Additionally, the US rate hike trajectory also remains uncertain and the RBI would also likely want to see how US data pans out. NAB's expectations are for two hikes of 25bps each in H2.

Chart 7: Consumption is the most robust GDP driver



Source: NAB, CEIC

Chart 8: Controlling inflation is key to boosting INR NEER



Source: NAB, CEIC

Singapore Spotlight: MAS to stand pat

- **Q4 GDP 2015 suggests growth momentum is still rather strong, especially in the services sector**
- **Core inflation remains low but robust and is starting to climb**
- **Hot money flows likely to continue to dominate the USD/SGD movements but attention should start to shift to April's MAS policy meeting**

The Q4 2015 GDP number paints the Singapore economy as full of vim, but this might not prove to be too enduring, with even the authorities not reacting to it much and leaving the 2016 outlook at 1-3%.

Nevertheless, for the time being, the strong growth number, resilient core inflation and tight labour market all point to a lower likelihood of the authorities adjusting their monetary policy stance in the expansionary direction.

This should leave the S$NEER to drift in the lower half of the policy band. While the SGD is more affected by outflows out of Emerging Markets (due to Singapore's status as a financial centre), many of its regional counterparts face even greater pressure from a combination of political uncertainty and exposure to commodities.

Strong growth might not endure

While the growth rate in the services sector has been fairly resilient over the last few quarters, the sharp weakness in EM markets (including EM Asia) and a broad flight to safety could hurt the financial services sector, which has been a mainstay of services. Notably, loan growth to businesses, both in SGD and foreign currencies, slowed sharply in Q4 2015 and might have persisted in January 2016 as well.

Furthermore, construction might also not sustain the same rate of sequential growth. The surge in construction might also prove unsustainable given that the Q4 number probably contains some amount of frontloading of future activity. There is a good chance that the government will continue to run a fiscal deficit in the 2016 budget (to be announced in March) given the multi-year nature of the infrastructure projects (mostly mass transit rail) that the government embarked on last year.

Manufacturing is likely to remain in the doldrums as it continues to play its role as a sunset industry. The US recovery is likely to continue to devoid of a huge surge in demand for manufactured goods.

The authorities' maintenance of the 2016 growth rate therefore is not unreasonable, especially with uncertainty in global financial markets still high. What was somewhat interesting though is that the authorities highlighted the fact that labour constraints were weighing on some services sectors – Commerce (Wholesale & Retail Trade) and Info-Comm were two of the fastest growing sectors in 2015 (+6.1% and +4.2%) but both are expecting a sharp fall in operating receipts in Q1 2016. These two sectors accounted for 23% of GDP in 2015, with survey respondents in Commerce also expecting a sharp fall in the sector's employment in Q1 2015.

Inflation remains fairly robust

The MAS core inflation measure continues to remain fairly buoyant in the 0.2-0.6% yoy range, with faint signs of a mild pick up in the rate. A pick up in motor vehicle demand could help lift overall headline inflation. While inflation remains fairly benign, it also does not provide sufficient reason for the authorities to seriously consider shifting towards a more accommodative monetary policy stance.

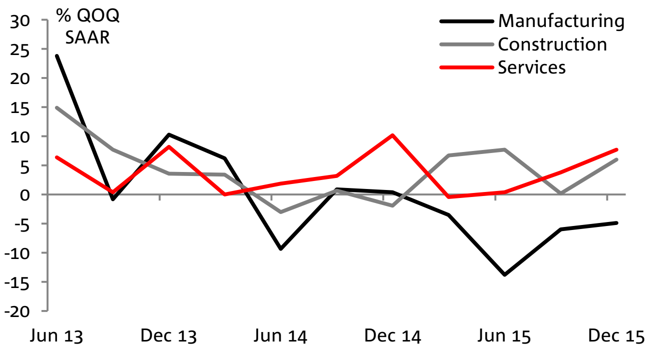
Labour market tightness might get more attention

With the overall unemployment rate at 1.6% and resident unemployment rate at 2.4%, and real GDP growth averaging 3.4% over the last four years, the economy is running close to or even above full employment, so monetary stimulus is still not going to be effective. Additionally, the government is already running a fiscal deficit of around 1.5% of GDP and could well extend it further given that the ongoing extension to the Mass Rapid Transit system, the Downtown Line, is scheduled to be completed only in 2024.

Insufficient recession risks for MAS to shift in April

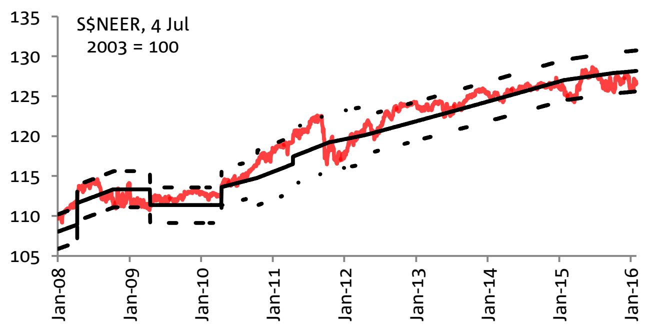
It is thus more likely that the authorities might opt for a loosening the immigration laws as the first line of support for the economy. Focus on the MAS policy meeting in April will increase in coming weeks and in our view, recession risks are still very low. With the current gradient of the S$NEER at a modest 0.5% per annum, we expect the MAS to hold off any changes in April. Market estimates may lean toward a reduction in the slope to neutral, and keep USD/SGD supported.

Chart 9: Services and construction driving economy



Source: NAB, CEIC

Chart 10: S$NEER remains comfortable in the policy band



Source: NAB, CEIC

Selected Indicators

Table 1: NAB 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	4.75	4.76	4.66	4.56	4.69	4.73	4.86	4.89
AUD/IDR	9936	9940	9660	9447	10005	10150	10440	10585
AUD/INR	48.2	47.2	45.9	44.2	45.5	45.9	46.8	46.7
AUD/KRW	878	888	863	838	828	840	850	840
AUD/MYR	3.10	3.05	3.00	2.95	3.04	3.08	3.15	3.18
AUD/PHP	34.6	34.8	32.8	32.2	33.1	33.3	33.8	33.9
AUD/SGD	1.04	1.03	1.01	0.99	1.01	1.02	1.04	1.06
AUD/THB	26.28	26.27	25.88	25.46	25.88	26.25	27.00	27.38
AUD/TWD	24.12	24.14	23.81	23.32	24.15	24.50	25.06	25.19

Table 2: NAB Key FX Forecasts

		Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Australian Dollar	AUD/USD	0.72	0.71	0.69	0.67	0.69	0.70	0.72	0.73
New Zealand Dollar	NZD/USD	0.65	0.64	0.62	0.60	0.61	0.62	0.63	0.65
Japanese yen	USD/JPY	115	116	117	118	119	119	121	121
Euro	EUR/USD	1.09	1.10	1.09	1.08	1.08	1.09	1.10	1.10
British Pound	GBP/USD	1.35	1.40	1.41	1.42	1.43	1.44	1.44	1.45
Swiss Franc	USD/CHF	1.00	1.00	1.02	1.05	1.05	1.05	1.04	1.05
Canadian Dollar	USD/CAD	1.34	1.36	1.43	1.49	1.44	1.43	1.41	1.40
Chinese New Yuan	USD/CNY	6.60	6.70	6.75	6.80	6.80	6.75	6.75	6.70

Table 3: NAB Asia Macro Forecasts

Average annual growth in GDP (%)

	2013	2014	2015	2016	2017
Hong Kong	3.1	2.5	2.5	2.6	2.6
Indonesia	5.6	5.0	4.8	4.5	4.5
Singapore	4.4	2.9	2.2	2.9	2.9
Taiwan	2.2	3.9	0.9	0.5	0.5
Thailand	2.7	0.8	2.8	3.8	3.8
Malaysia	4.7	6.0	6.1	4.3	4.3
S Korea	2.9	3.3	2.6	2.9	2.9
Philippines	7.1	6.1	5.8	5.7	5.7
Total	**4.2**	**4.1**	**3.6**	**3.5**	**3.5**
China	7.7	7.3	6.9	6.7	6.5
India	6.4	7.1	7.5	7.6	7.4

Table 4: 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	2.4	2.2	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	2.2	2.2	2.2
Emerging Asia	4.4	4.6	4.2	4.1	3.6	3.6	3.8
Latin America	4.9	2.5	2.6	0.9	-0.4	-0.3	1.2
China	9.3	7.8	7.7	7.3	6.9	6.7	6.5
Canada	3.0	1.9	2.0	2.5	1.2	1.7	2.0
Australia	2.7	3.5	2.0	2.6	2.3	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	3.5	4.0	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	2.8	2.5	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**	**3.32**	**2.92**	**3.02**	**3.27**

Source all tables: National Australia Bank

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