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REPORT
Asia's Macroeconomic Outlook – Will Asia Tighten First?

Mirza Baig
Morgan Stanley Singapore

FEBRUARY 13TH 2021

Asia's Macroeconomic Outlook – Will Asia Tighten First?

Asia has rebounded from the pandemic induced economic shutdown with a clear strategic advantage. Led by China, Asia's handling of the pandemic and its economic recovery has been the envy of the globe. Are asset prices reflecting this, and can Asia consolidate this economic momentum? Does Asia's economic preeminence prompt a re-rating of assets that appear well supported by a historically low funding cost? I discuss the prevailing macro outlook for Asia, especially China with,

Mirza Baig — macro desk strategist at Morgan Stanley, Singapore

Relentless price gains and the absence of a sizable correction in recent years driven by anything but a hawkish Federal Reserve reinforces the notion that low rates and ample liquidity will underwrite prices for as long as this policy remains. As such, the only threat to continued equity strength across the globe is the punch bowl being removed. While the Federal Reserve remains the primary driver of global sentiment, investors are increasingly concerned about the idea of a premature tightening with Asia and particularly China, being the source of angst.

This is the crux of my discussion with Mirza where we:

Discuss the Chinese economy's current economic momentum and whether this can prompt the PBOC into a tightening cycle.

Will a weaker credit impulse translate to cyclical/commodity price decline?

Discuss dynamics around the RMB, Capital Account reforms, and the impact of equity and bond flows.

Chat about the impact of Korean retail investors', who put the "Reddit Army" to shame, and vulnerabilities created by a stronger Taiwan Dollar.

Overall, our conversation continually harks back to one overriding question:

Will Asia tighten first?

While the factors driving structural inflows remain vibrant, relative policy will be a crucial driver of comparative performance across the region and versus the United States over the quarters ahead.

Please note, the following are not direct quotes from Mirza but my interpretation based on our conversation

By **Paul Krake**, paul@viewfromthepeak.com.hk;
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China’s Economic Momentum

Mirza: China was one of the first countries to bring the virus under control within its borders, and its economy rebounded quickly without a large amount of monetary stimulus. Due to fiscal pump-priming and some degree of monetary expansion, the economy was on track for a continued growth year by the end of 2020, yet the marginal momentum and second derivative appear to have slowed down in January.

Last month’s PMI numbers have been weaker than expected, and funding for infrastructure projects last year from government bond issuance is not expected to match 2020 growth rates. To some extent, the tweaks in monetary policy mean that marginal momentum is slowing down, but overall, the economic recovery continues to progress.

China’s Potential Tightening Cycle

Discuss whether China is potentially entering a tightening cycle and what form could this tightening take?

Mirza: Chinese policymakers’ top priority is to maintain a stable economy and stimulus with no cliff effects so that a tightening of policies does not disrupt the economy. The PBOC tweaks its policies to a limited extent — insofar as responding to asset price bubbles that are reaching an upper limit — while still maintaining policy stability. There is a disparity between the words of certain PBOC officials and general policymakers compared to their actions in the market.

The PBOC injected excess liquidity in the money markets in the first few weeks of January. While some thought that they wanted to drive down inflows to the currency, seeing that the USD-RMB rate stopped falling, the PBOC then tightened liquidity in the second half of January, and liquidity was squeezed hard at the end of the month, demonstrating their desire to tamper down asset price bubbles.

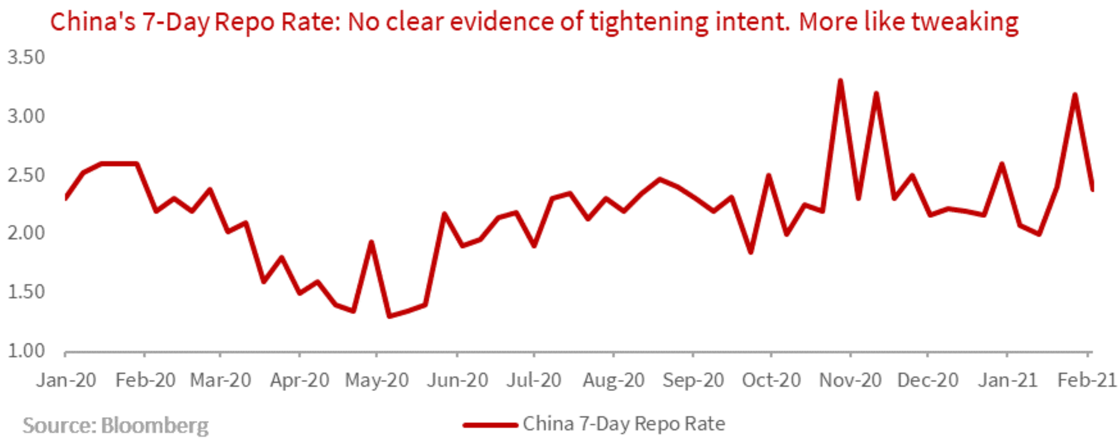
Overall, the PBOC is not starting a tightening cycle, but it is sporadically tightening liquidity to show its awareness of asset price bubbles.

Will any form of tightening cycle in China begin before it happens in Western countries?

Mirza: Concerns over asset price inflation is not limited to China. In South Korea, the government puts pressure on the central bank to increase rates to ensure property prices do not drastically increase, which has become an election issue. Government ministers in Singapore have also publicly voiced concerns about the property market. Thus, China may be the largest case of asset price inflation concerns, but the worry is shared across several central banks and policymakers in Asia. In contrast, the Federal Reserve and ECB are solely concerned about headline CPI inflation rather than asset prices.

Among Asian banks, the PBOC may tighten before the Fed, but it brings into question what policy tools — including the seven-day repo corridor and adjusting SLF and MLF rates — are available.

With many different tools at their disposal, the PBOC may avoid interest rate hikes because of the impact such an action could have —Chinese policy continues to be one that maintains support for the economy — while avoiding excessive currency appreciation pressure.



Overall, the PBOC will continue to use liquidity measures to incrementally tighten monetary policy, even if the Fed is not doing the same.

Will the PBOC's heavier focus on asset values compared to the Federal Reserve and ECB mean Chinese risky assets will underperform the developed world?

Mirza: Yes and no. Policy is not the only driver of asset prices, and across Asia, there is a burgeoning retail movement. In South Korea, retail investors have been gaining a foothold in the stock market since late last year, repurchasing stocks from foreigners, while calls have been made in Taiwan to "take TSMC back from the foreigners." China has avoided this phenomenon so far, which has taken place in Asia's developed economies, where the retail investor community is much more active. Thus, asset prices are driven by other factors beyond policy.

Shrinking Credit

Consumer lending has become one 'excess' part of the economy. Can it be argued that the regulation of Ant Group is a defacto tightening?

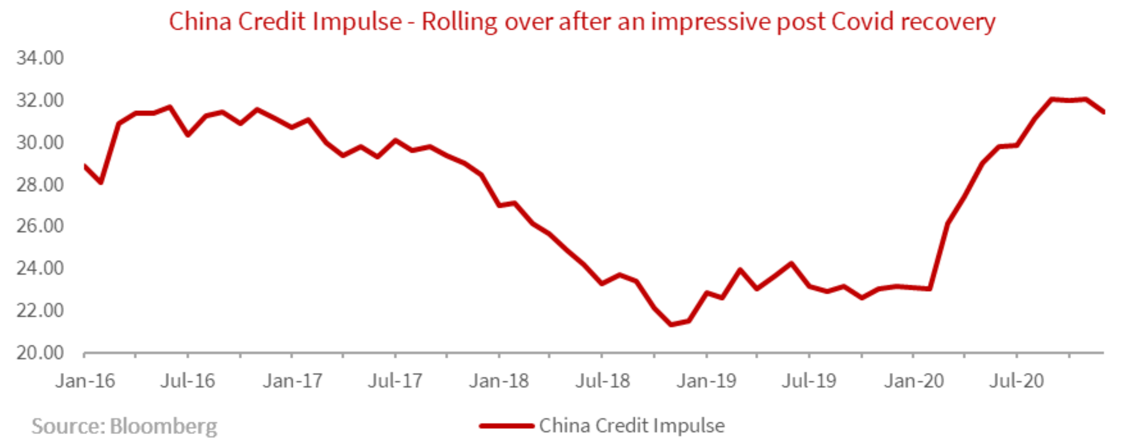
Mirza: Across the board, there is a natural slowdown in fiscal impulse from Chinese credit. However, these may not have macro implications that impact the growth trajectory in sectors such as import demand as well as the bond and currency markets in China.

One may be more worried about a scenario similar to 2018, where Chinese policymakers decided to crack down on shadow banking, curtail the consumer lending business, and focus on overall systemic deleveraging. This likely will not happen in a year hallmarked by the Chinese Communist Party's centennial and the first full year after containing COVID-19. Rather than deleveraging, authorities are focused on maintaining stability and the overall macro leverage. I believe that targeting the consumer sector may not translate into an overall macro-economic slowdown.

Do the same rules apply for cyclical companies and commodity prices that a weaker credit impulse will lead to lower commodity prices?

Chinese credit impulse is perhaps the most reliable macro indicator for commodity prices, given that China tends to provide demand delta and Chinese credit cycles tend to be oriented towards boom and bust. Some key points are as follows:

- Chinese credit impulse has shot up lately, leading to rising commodity prices, but which is now backing down. More monetary tightening may be possible if bank lending data is above market expectations. For now, the Chinese credit impulse is likely to continue decreasing, relative to where commodity prices currently stand.



- A correction has been observed in commodities such as iron ore, as Chinese import demand for base metal and scrap metals appear to have peaked. The supply side is also tight in many commodities such as copper, where production levels in countries such as Chile, South Africa, and Peru are operating below pre-COVID levels of output.
- Gold experienced a similar trajectory — where demand surged, but mines shut down, leading to supply shortages — prices stabilized in a new range despite the supply side's recovery.
- The same could happen in iron ore and copper, both of which are driven by Chinese demand. While that demand turns down and supplies recover as vaccine rollouts continue, there will not be a collapse. I believe some of the excess capital dividend account positions in these could be quite vulnerable.

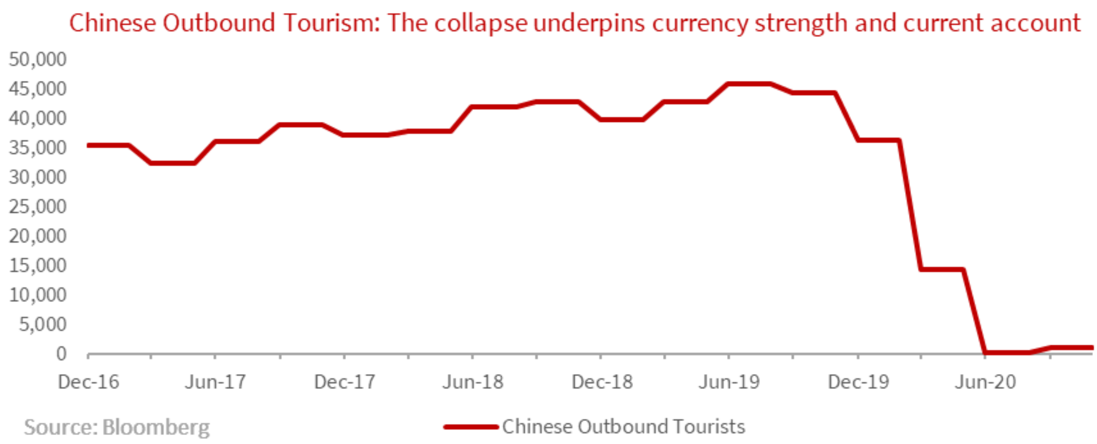
Outlook on the RMB

Considering that Beijing determines the RMB's mid-to-long-term direction, does a tightening cycle naturally lead to a stronger trade-weighted yuan? What are the economic and political catalysts for the RMB to continue appreciating?

Mirza: Insofar as monetary policy, that is correct. Long-term cycles show that policymakers do guide the path of the RMB through a cycle. In a scenario where the PBOC is actively tightening, and the Fed is not, one would expect that the dollar-yuan rate goes down.

However, it is important to remember that the PBOC is unlikely to create a policy divergence regime with the Federal Reserve, opting instead to tighten through more subtle ways or through restricting liquidity. I would pay attention to China's current account, which has increased by $180 billion in the last year, rising from around $160 to $180 billion to $240 to $260 billion, owing to the following reasons:

- Chinese exporters took on more market share while much of the world was shut down. And as Chinese tourists stopped traveling abroad, another substantial amount has remained in the current account—both aspects of driving currency strength right now.
- Outbound tourism from China will likely not recover this year, given the country's slow vaccination campaign. However, a recovery in global travel would take the upward pressure off from the RMB, as other countries gain the dollars that remain in China. This is a crucial focus, yet I do not see it happening in the short term.



Structurally, Chinese policymakers are veering away from a growth model of low-value, manufacture-driven business, which would benefit from a cheap currency.

China is pursuing a consumer- and tech-driven economy, and in such a scenario, a weak currency would act as a tax on consumers and subsidize exporters. This would go against the model that China is pursuing: high-margin business growth and consumers with higher relative purchasing power.

Is there a valid argument for RMB weakness?

Mirza: There are few reasons to choose a weaker currency. One possibility is the return of a trade war, in which a weaker currency would offset damages. Yet currency depreciation effectively tightens financial conditions because it stops the flow of dollars into the country and the ability for Chinese corporates to go abroad. While the RMB may depreciate due to market reasons, there are few reasons for deliberately preferring a devaluation.

Discuss the viability of the RMB as a monetary policy tool.

Mirza: The currency is seldom available to Chinese policymakers as a tool for cyclical management of the economy, but rather, a problem that tends to arise as a consequence of other policies. An excessive tightening of policy will cause the currency to appreciate. Similarly, during the trade war, the RMB's devaluation encouraged capital outflows, overtightening financial conditions and creating another unfavorable scenario. The RMB can be seen as such:

- China's size means that a move in its currency causes other currencies to move, thereby impacting politics and reactions from trade partners, making it difficult to make drastic changes.
- Chinese policymakers are much more concerned about moving away from the dollar-based system as a strategic goal to avoid the possibility of sanctions. For that reason, the internationalization of the RMB is a big goal.
- Few high-profile moves may occur this year, as the liberalization of capital account transactions and opening up the financial sectors are precursors to this goal.
- Chinese banks are setting up RMB processing and settlement centers in different cities; Manila, for instance, has seen a massive increase in RMB-denominated transactions.

To internationalize the yuan would require a strong currency, so cyclical and structural management both come into play.

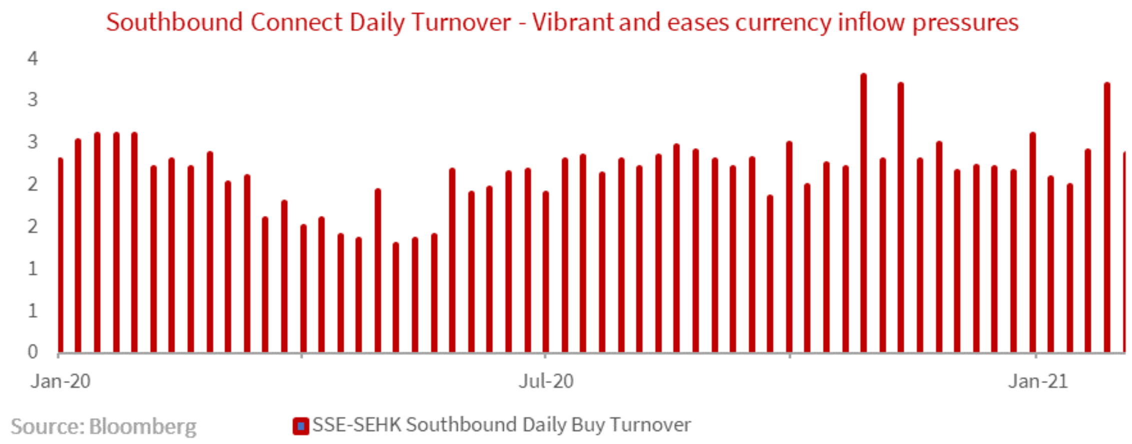
Are there benefits to advocating for the RMB as a rival to the dollar?

Mirza: More than anything, the essential goal is to circumvent the dollar-based system that currently makes China vulnerable to US sanctions. Being cut off from the international financial system is China's most significant vulnerability other than a military conflict in the South China Sea. Some may point out that it is also a matter of prestige, but I believe that it goes beyond that to a more fundamental need of not being at the mercy of the dollar.

Investment Flows

Discuss if the PBOC could be balancing out the anticipated flow of foreign investment into capital markets by tightening policy? What are the observations on security flows, equity, and fixed income into China since the start of this year?

Mirza: A rapid increase in southbound flows this year has been observed whereby onshore Chinese investors are flocking to Hong Kong. There is a reason to believe that this surge is driven by Chinese insurance companies who are being encouraged by policymakers, thus help to stop the RMB's appreciation in January. The proxies useful for tracking Chinese balance of payments — such as trade balance, net FX purchases, deposits, and settlements, among others — all show healthy surpluses since September last year. As Chinese officials needed to offset that, insurance companies were tasked with purchasing stocks in Hong Kong.



Moreover, some degree of liberalization is needed. One could expect further integration in the Greater Bay Area, where some limits on capital account transactions may be eased. Corporations operating in this region could have fewer restrictions on foreign securities investments, dividend repatriation, as well as overseas asset purchases. And to control the currency on a day-to-day basis, Chinese policymakers have two powerful, market-friendly tools at their disposal: controlling offshore CNH funding as well as southbound flows, i.e., from the mainland to Hong Kong.

The net outflow has been around $20 to $30 billion this past January, while data from bond flows, which is still not available, will likely show continued purchasing from foreigners.

Capital Account: Possible Reform?

Could capital account restrictions relax? What would the reason be for such capital account reform?

Mirza: Chinese policymakers are cautious about extensive reforms on outflows, but they are much more willing to complete smaller tweaks: that includes quotas for corporates to borrow in dollars, quotas on local governments to borrow offshore, CNH funding, and other regulations on existing institutions.

The reluctance is in part due to China's observation of the Japanese experience, as well as its botched devaluation of 2015. An open capital account requires interest rate stabilization and a stable banking system; while the former is well in place, the latter — including buffers for systemically important banks and hedge tools for risk management — are still works in progress. In this regard, a place such as the Greater Bay Area could serve as a test case for freer access to dollars, as well as the loosening of other restrictions.

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South Korea: The dominance of retail equity investors

Housing affordability in South Korea is an election issue. What are two things we need to know?

Mirza: Firstly, Korean retail investors in the stock market are sophisticated. Daily trading volume among retail investment comes to around $8 to $10 billion, and this slow pressure has reserved the trend in the Korean Won, as these stocks are being bought from foreigners. Foreigners are then repatriating into US dollars, and the Dollar-Won rate has increased 3% year-to-date.

In other words, the currency depreciated 3% due to retail flows. Korea's current account surplus is enormous, but retail investors are buying positions and becoming the dominant flow. This is certainly a new phenomenon.

Secondly, Korea's monetary policy should be closely watched, as due to asset price inflation concerns, the Bank of Korea could hike rates before the Federal Reserve.

Taiwan: The vulnerabilities of a stronger currency

Discuss one critical issue in Taiwan apart from TSMC.

Mirza: In Taiwan, life insurance companies have large dollar assets, and their capital buffers are extremely thin, and a 2%-5% currency appreciation effectively leaves them with a capital shortfall. Their dollar assets are hedged, and the cost of doing so in a very narrow non-deliverable forward (NDF) market drives NDF points to astronomical levels. In December, the implied yields in NDFs were around negative 15%.

Regarding the capital account, the natural outflows from Taiwan that used to offset the current account surplus are no longer there, and the overhang of $500 billion of overseas assets held by insurance companies needs to be hedged. While the cost of hedging pushes NDF points to extreme negative yields, the Taiwanese dollar's strength is the cause of continual pain.

Is there any systemic risk to the insurance sector and the financial system as a whole? Are investors pricing a risk premium into Taiwan assets based on geopolitical concerns?

Mirza: The risk of a systemic crisis to the financial system is small. Most of these companies are owned by wealthy individuals with their own financial holding companies, and they — along with those who bought policies — may be the ones most affected.

Geopolitical risk is non-negligible, but it is impossible to trade that risk. There is some demand for tail protection from equity investors with very high strikes in Taiwanese dollars, e.g., 8% to 10% strikes above spot, which is roughly almost no cost. The risk cannot be dismissed, and barring an actual exchange of live fire, the market is adjusting to this reality of high tension.

Singapore – MAS Watch

For Singapore, what role will the Monetary Authority play?

Mirza: Singaporean policymakers have voice public concerns over property prices heating up, and while property prices have not been in the Monetary Authority's mandate since the organization has a currency-based monetary policy. Yet these warnings give the central bank guidance, namely that a tightening of liquidity would be permissible.

However, the MAS has few options to control property prices, seeing that currency — not interest rate — is their primary tool. Ultimately, while the government may intervene with their measures, the possibility of marginal tightening of liquidity based on property price concerns exist.

In summary, Asian currencies are driven by growth expectations of the global economy and the movement of the US dollar. As they are well-owned, it is difficult to identify specific value. While January consensus themes, i.e., a sharply weaker dollar, have stalled, the market needs to go through a period of pain trade, lightening positions, and squeezes. Asian banks are more hawkish than the Fed on their asset prices, skewing risk towards the currencies, but there are also other considerations taking place across Asian economies.

Conclusion – Will Asia Tighten First?

While the Federal Reserve remains the primary driver of global sentiment, investors are increasingly concerned about the idea of a premature tightening with Asia and particularly China, being the source of angst.

China has been draining liquidity, and we have evidence that activity is peaking. Regulations over Ant Group and the establishment of a bank holding company will temper their consumer credit activities as the fintech behemoth is forced to provide more capital against each liability. This is a defacto tightening in itself. Politicians from Taiwan and South Korea are discussing asset bubbles. What is very clear is that Asian authorities are taking the asset excesses of unprecedented global liquidity much more seriously than developed market peers.

While Asia worries about the potential for property market extremes, American politicians banter back and forth about why the little guy can't enjoy the spoils. I suppose that is their way of dealing with unmatched economic inequality. In that case, the prospect of a US tightening of either fiscal or monetary policy is a long way away, and many in the political class, especially the newly emboldened Left of the Democratic Party, will fight any form of austerity. This leaves us with a potential disconnect between Asian and Western Policy.

With Asian Authorities being much more focused on asset bubbles than the US or EU, are we about to see divergent monetary policy for the first time in many, many years?

Let us take this one step further: If the United States continues to embrace the corporate welfare state that underwrites investment-grade corporates through bond purchases, don't US equities outperform those countries who refuse to do the same? If Washington is to conduct policy and runs twin deficits that will exceed 20% of GDP, how do Asian assets compete when domestic liquidity conditions are so much tighter? These are valid questions and must have consequences for asset allocation in the quarters ahead.

I have several observations:

1) Asian policy has been much tighter than the US and EU. So, from a relative policy standpoint, we are already living the aforementioned reality.

2) The Federal Reserve drives global risk assets and beta. The Fed is a rising tide that lifts all boats, and global assets will be supportive provided the Fed stays the course.

3) Policy tightening is relative. While China, South Korea, and Taiwan may tinker with policy, Asia doesn't have an inflation problem, and while some liquidity could be drained, a full-blown tightening cycle is a long way away. This tightening cycle would be most unlikely unless the Fed hinted it was moving in the same direction.

Lost in the shenanigans over Gamestop was a Fed meeting where the message could not have been more explicit. Global USD liquidity conditions will remain abundant, and concerns about tapering, prompting the inevitable fixed income tantrum, seem a long way off. While the yield curve steepening of recent weeks is emboldening inflation hawks, the liquidity conditions that underwrite emerging market assets remain intact. Fed policy is remarkably constructive for Asia even in the event of policy that is much less loose than what is witnessed in the United States.

Policy divergence is rare—about as rare as long-term underperformance of US assets. Tighter Asian policy is a net drag on Asian assets, but a continuation of loose USD liquidity will swamp this and ensure continued asset strength across the globe.

I have worked on the notion that MSCI world will rally 20% in 2021, but the divergence of performance between markets will be negligible. Slightly tighter Asian monetary policy isn't a signal to sell emerging market exposures, but it should prompt you to re-think your strategy that it is time to dump US equities for the balance of the globe. Dumping assets comes when the Fed talks about tightening, not when Asia discusses it.

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