



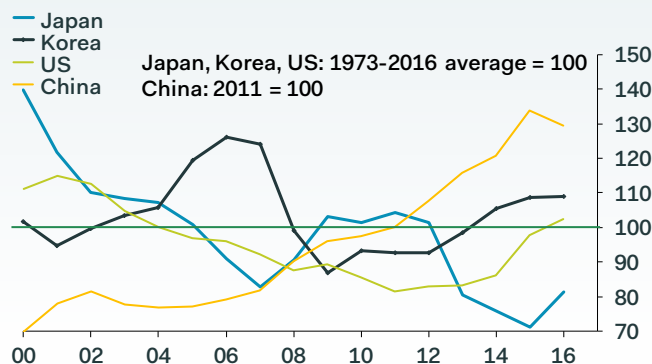
THE ASIAN ECONOMIES IN H2 2017

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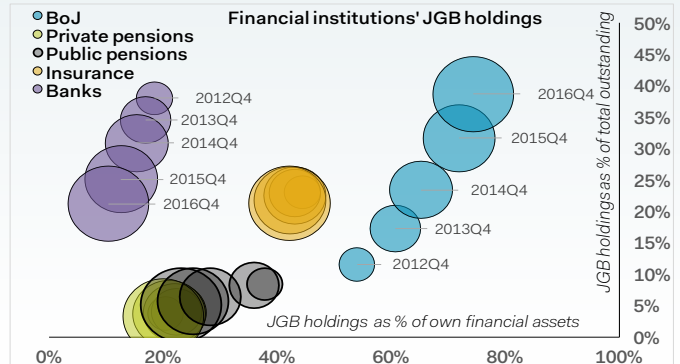
Higher Global Rates Depress China but Stimulate Japan, for now

- * China and Korea face weakening growth and decelerating underlying inflation in the second half. Japanese growth is also likely to slow but will remain above trend thanks to a weak yen, strong external demand and momentum spreading beyond export-oriented firms. **Rising global interest rates will intensify the divergence between Asia's key economies, due to sharply contrasting monetary policy frameworks.**
- * The election of Mr. Trump last year gave us a clue as to how the global reflation trade affects Asia. China responded to higher external yields through a combination of capital controls, higher domestic interest rates and modest depreciation of the RMB. Japan's response was already baked-in, thanks to the yield-curve targeting framework. The vast bulk of the adjustment between Japan and the rest of the world was done through yen depreciation and the tiny tantrum in global bond yields in early July proves that this mechanism is still in play. **Both policy regimes are rigid but in very different ways.**
- * **We expect the second leg of the reflation trade to push Chinese and Japanese policy frameworks to the limits.** China's over-leveraged corporate sector cannot cope with higher interest rates. Policymakers probably will keep the currency up before the Party Congress in autumn but the pressure will eventually become too great, and China now has few incentives to keep burning through its FX reserves.
- * Higher interest rates will expose Chinese bad debts. **Ultimately, China will have to recapitalise the banking system, forcing the PBoC to print money, sending the RMB lower.** The timing is difficult to predict but the forecast rise in interest rates over the next 12-18 months is likely to be enough to catalyse big changes in China, particularly as the yen depreciates, heaping yet more pressure on regional exporters.
- * **The BoJ will eventually capitulate to higher yields, moving the 10-year target up from zero to 20bp before the end of the year, in the face of a weakening yen.** The policy rate is also likely to be increased to zero from -0.1%. But don't expect a lasting yen rally. **Korean monetary policy will probably go down the middle, allowing the economy to adjust through a combination of both a weaker won and higher long-end rates.** But the fragility of the household and construction sectors will mean Korea will hold off from raising policy rates, implying a steepening of the yield curve.

CHINA STANDS OUT GLOBALLY AS UNCOMPETITIVE

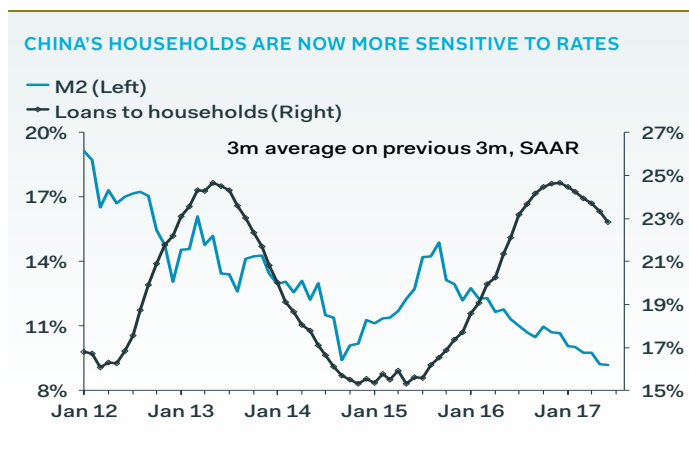
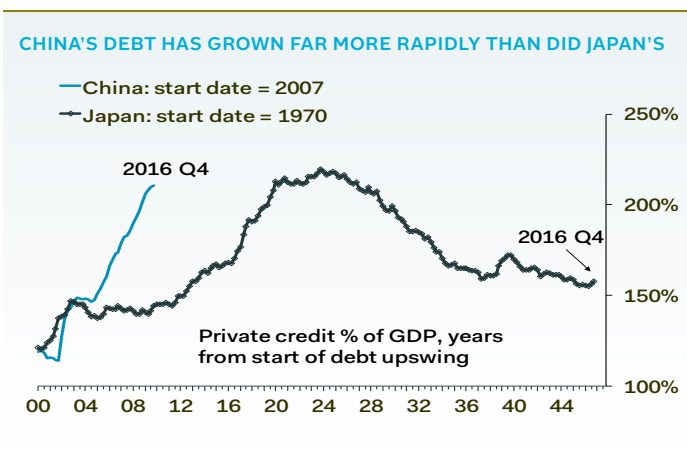


THE BOJ HAS OFFERED NO EXIT PLAN



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- * **All three economies are exposed in different ways to the forecast rise in the global interest rates.** All are excess savers; they rely on unsustainable domestic investment or foreign borrowing and consumption to use up their savings and supplement their deficient consumption demand. Since the global financial crisis, Asian economies have had to bear the burden themselves. Japan responded by devaluing. Korea fell back on the old driver of rising household debt. But the RMB has remained overvalued, forcing China to increase its internal deficits, resulting in the huge run up in corporate debt since 2011.
- * The Chinese household sector also is now exposed to the likely rise in interest rates. In 2015-to-16, as corporates retrenched, households ramped up their mortgage borrowing, with much of the funding headed for investment rather than occupancy. **The property market, therefore, is in for a steeper downturn this time around.** The consequences for GDP growth are serious; property development and related industries could be as much as 20% of GDP. But the repercussions go well beyond real growth. Real estate developers have huge pools of debt, and a housing market downturn would damage their servicing ability, potentially forcing fire sales of inventory.
- * The Japanese non-bank private sector is much less sensitive to interest rates than their Chinese and Korean peers. But the banks' balance sheet is likely more fragile than the non-bank private sector financial accounts would suggest. Banks are exposed to a rise in foreign yields through their holdings of external debt. If global yields rise as we expect, banks will have to register losses on mark-to-market bonds outside the held-to-maturity account. Banks would then have to reduce leverage to meet regulatory requirements, potentially forcing them to pay-off their own short-term dollar financing with yen liquidity, exacerbating any depreciation in the yen. **This is a tail risk, which we will be monitoring closely through the second half.**
- * Chinese growth would slow even without an increase in interest rates. GDP growth in the last few quarters has been powered by the industrial complex. Quarterly growth in Q2 will be decent but slower than the speedy rate of Q1. **But businesses will run out of steam in the second half as pent-up demand burns out.** Higher interest rates are likely to re-focus minds on the task of deleveraging, intensifying the downturn. Households are unlikely to drive the economy as they did in 2016. The recent GDP recovery has stabilised the labour market but manufacturing employment PMIs failed to reach 50 and GDP growth is now turning back down. Growth in household consumption and home purchases are likely to decelerate rapidly in H2.
- * Abenomics is going through a renaissance of real growth, just as the electorate begins to reject the programme. Real GDP growth has been positive and above trend for two years. Corporate borrowing has re-awoken and the recovery has gathered such pace that even small businesses are benefiting. **Japan Inc finally appears competitive and nominal wage growth is also likely to pick up in the second half, though real wage growth will continue to disappoint the angry electorate.**



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GDP (year-over-year, %)

	2014	2015	2016	2017F	2018F
China	7.2	6.8	6.8	6.8	6.5
Japan	-0.3	1.0	1.6	1.1	0.7
South Korea	1.9	2.3	1.7	3.0	2.0

Inflation, (year-over-year, %)

China <i>CPI</i>	1.5	1.6	2.1	1.8	1.1
China <i>PPI</i>	-3.3	-5.9	5.5	3.8	2.4
Japan	2.4	0.2	0.3	0.5	1.2
South Korea	0.8	1.1	1.3	1.4	1.0

Monetary Policy (end of year)

China <i>MLF 1-year</i>	--	--	3.00	3.30	3.00
China <i>PBoC reverse-repo rate</i>	--	2.25	2.25	2.55	2.25
Japan <i>10-year yield target</i>	--	--	0.00	0.20	0.40
Japan <i>Policy rate</i>	--	--	-0.10	0.00	0.20
South Korea <i>Policy rate</i>	2.00	1.50	1.25	1.25	1.00

Currency /USD (end of year)

China	6.21	6.49	6.96	7.00	7.50
Japan	119.78	120.22	116.05	116.00	118.00
South Korea	1099	1172	1192	1182	1190