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# ASIA'S FUTURE: NO ESCAPE FROM THE US

Love it or hate it, Asia is inextricably tied into the US and however much China has grown in importance, it is still the US which will be the principal driver of Asia's fortunes in the next few years. The good news is that the American economy appears poised for a strong pickup, one which will give a nice boost to the Asian economies. But beyond that cyclical bounce, several things could go wrong - financial turbulence from a strong US Dollar coupled with rising US rates, a slide into protectionism and a strategic approach to the Asian region which could add further uncertainty in the region.

## US economy poised for a strong run

Taking all the data in the recent weeks together and despite the occasional setback, there is growing evidence that the US economy is not only gaining momentum but that the acceleration is likely to be sustained for a while:

- **Activity indicators signalling strength:** Both the manufacturing as well as non-manufacturing purchasing manager indices have gained strength, with new orders growing at an energetic rate which points to expanding economic activity in coming months.

- **Federal Reserve Bank's Beige Book survey revealed growing demand for workers and rising wages**: The past two months have seen further tightening of labour markets, resulting in more instances of labour shortages, not just in high-skilled engineering and technology-related professions but even in blue-collar construction and manufacturing. As a result, moderate increases in wages have been seen in most districts.

- **Bullish consumers likely to boost retail sales and housing**: That improvement in job and wage prospects probably explains why consumers are increasingly more optimistic: The Conference Board's Consumer Confidence Index reached a 15-year high in February. This ebullience in consumers should also translate into further strength in US housing. After all, American home ownership rates are still at multi-decade lows, so more confidence about jobs and further wage growth is likely to translate into stronger housing demand, giving an extra fillip to domestic demand.

- **American business confidence also at decade-high**: Surveys by JP Morgan of middle market business leaders as well as a separate survey of small firms showed heady levels of business optimism not seen for a decade. The ongoing economic recovery helps but so do expectations that the Trump Administration and its Republican allies will deliver higher fiscal spending, lower taxes and more deregulation that would improve sales and profits. President Trump's inaugural budget proposal envisaged a colossal USD54bn rise in military spending. That could translate into a huge boost for the high technology sector given the technological intensity of new age defence strategy. The multiplier effects of this defence expansion could be very substantial.

- **Recoveries in the US, Eurozone and Japan mutually reinforcing each other**: More robust demand in the US will spill over into the other large economies that are its main trading partners, helping their economic recoveries to take flight. Economic data in both the Eurozone and Japan have surprised positively in recent weeks, even before the full effect of the American acceleration was felt, which tells us that these large economies are putting much of their recent weakness behind. That could also explain the surge in new orders for American services companies – most likely reflecting this spillover from Japanese and European recoveries.

All this bodes well for Asian economies where exports are already reviving in line with a gathering rebound in world trade. And this improvement in trade prospects is also flowing through to stronger industrial production. In addition, improving global demand is also pushing up oil, coal and metal prices which in turn supports faster income growth in Asia as well as more government revenues.

**But, get ready for more financial turbulence**

A parade of other Fed officials including Fed Chairperson Janet Yellen, Vice-Chair Stanley Fischer and the dovish Lael Brainard have spoken recently, making it clear that the Fed will be raising rates faster than expected. Despite this precipitating a sharp change in market expectations of a rate hike and unlike previous periods such changes in expectations of monetary tightening such as the May 2013 taper tantrums, Asian financial markets did not suffer too much – none of the surges in capital outflows or abrupt currency depreciations that we saw in the past.

However, investors would be complacent if they believed that a rising US Dollar and higher US interest rates would not cause turbulence in Asia over time:

- First, for now, the markets seem to be assuming that the two to three rate hikes they had been expecting for this year are simply happening a little earlier. But, the upward spiral in US economic activity described above will, we think, force the Fed into at least 3 or 4 hikes this year and even more aggressive tightening in 2018. As the markets price this in, the pressure on Asian asset markets and currencies will increase.

- Second, the recent bullish moves in equities were probably fuelled by investors moving cash into financial assets rather than them re-allocating existing funds out of emerging market assets. In time, the latter is more likely and that will hurt Asian asset prices and currencies.

The potential damage goes beyond just falls in equity valuations or currencies. At a time US Dollar-denominated debt in emerging economies has surged, a stronger Dollar and higher Dollar interest rates will increase the repayment burdens on these companies. As it is, about

10% of such debt owed by emerging economy companies is due for repayment this year: there are bound to be stresses as a result.

**Trade policy changes are a real risk for Asia**

It is clear that the Trump Administration and the US Congress are planning major changes that could cause much disruption in trade-dependent Asian economies.

- **A border adjustment tax would be decidedly bad for Asia**: The Republican party leadership in the US Congress is advocating a border adjustment tax (BAT), which in effect subsidies US exports while imposing a tax penalty on imported goods. Because it is such a controversial proposal which could raise the cost of living for Americans, President Trump has stopped short of endorsing it while well-funded lobbyists are mobilising public opinion against it. Still, we believe that some form of a BAT will prove too attractive for the President and Congress – the BAT is the only reform option they have which promises the massive bounty of tax revenues that they need to bring coherence to conflicting goals of a massive rise in defence and infrastructure spending, huge tax cuts and no major worsening of the fiscal deficit. After all, Trump continues to rail against the alleged asymmetry in the treatment of American exports and called for a 'level playing field' for American exports. More than that, the BAT will disrupt existing supply chains in which Asian exporters have thrived while almost certainly provoking retaliation by major trading partners, thus risking the continued expansion of trade that is so vital to Asia's growth.

- **Worse still, Trump's approach could disrupt the existing trade order**: A leaked report suggests that the Trump Administration is prepared to ignore any World Trade Organisation (WTO) rulings they do not agree with, with a promise to "aggressively defend American sovereignty over matters of trade policy." Trump's disdain for the WTO which he dismissed as a "disaster" during his election campaign could lead to a more aggressive use of laws like the old Section 301 Trade Act of 1974, which allowed the President to determine if practices unjustifiably restrict US commerce. Such measures were last used against Japan in the 1980s at a dark time for world trade and their repetition in this age would send a collective chill down Asians' spines.

**Trump Administration's strategic approach may not help Asia**

The new American administration plans to substantially raise American defence spending, funding this expansion through a huge cut in the budget for US aid and diplomacy. In addition, the administration is also adopting a stridently nationalistic tone in economic relations with Asian allies. Despite the best efforts of his Defence Secretary and Secretary of State, President Trump seems to be shifting American strategy away from soft power and towards hard power and appears to place less value on longstanding strategic relations with Asian allies.

Whether an approach that makes allies nervous and relies so much on a large increase in military assets which will only become available in several years' time is the best way of dealing with current security challenges in Asia is a moot question. All this is happening as the strategic position in East Asia has changed decisively for the worse. China has already established a military position in the South China Sea that puts the US on the back foot and makes it almost impossible for other nations with territorial claims to protect their positions. And North Korea, having made progress in developing a deterrent based on nuclear weapons and missiles that could in time threaten the US, feels it can engage in ever more brazen acts in countries that never thought they could become victims of that regime's extraordinary behaviour – as Malaysia has learnt. Nothing in the new American approach will help it deal with North Korea.

Moreover, the Trump Administration is aggressively pushing through a radical policy agenda on the basis of a weak electoral mandate, almost guaranteeing a large political backlash and endless controversies which will sap the Administration's energies, leaving little bandwidth for foreign policy. Many Asian nations are looking at the increasingly gridlocked and fractious American political system which is also more aggressively nationalistic and contrasting it with the Chinese system which seems to deliver more coherent policies and which is extending its soft power through well-funded overtures to Asians such as the One Belt One Road initiative. Some of them may well choose to re-align themselves with the rising Chinese power than an American system they have less and less confidence in.

Some may argue that the Trump Administration is still taking shape and that it is premature to be pessimistic. However, the instincts of the President and his key advisors are quite clear and they are unlikely to change.

### Conclusion

We think that in the near term, the US recovery will provide a larger boost to Asian economic prospects than expected. But, we also see monetary policy normalisation proceeding in a more disruptive manner than many think. However, the greater concerns are first, trade policy and second, the geo-political risks in Asia. These risks may seem far away for some of us but we should not be complacent. Asia is in for a rough ride.

**Prepared by Manu Bhaskaran, CEO, Centennial Asia Advisors**