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MACRO MORNING BRIEFING

August 2, 2024

Diverging China vs. APAC PMI & RBA Preview

Business sentiment as measured by Purchasing Manager Indexes divergence continues into the second half of the year with contraction in China against expansion for the rest of the APAC region.

China manufacturing PMI posted the third straight month in contraction at 49.4. The three key subcomponents we track are below 50 – New Orders at 49.3 (-0.2), New Export Orders at 48.5 (+0.2) and Imports at 47.0 (+0.1). Elsewhere, input prices, at 49.9, fell into contraction for the first time since June 2023, and the production index eased to a neutral level at 50.1, down from its high of 52.9 in April. Adding to the fragile sentiment is the surprise drop in Caixin PMI, which surveys sample export-oriented and small to medium enterprises, to 49.8, after having remained in expansion mode since late 2023. Near-term heightened geopolitical tensions and slowing global demand may weigh further on China business sentiment.

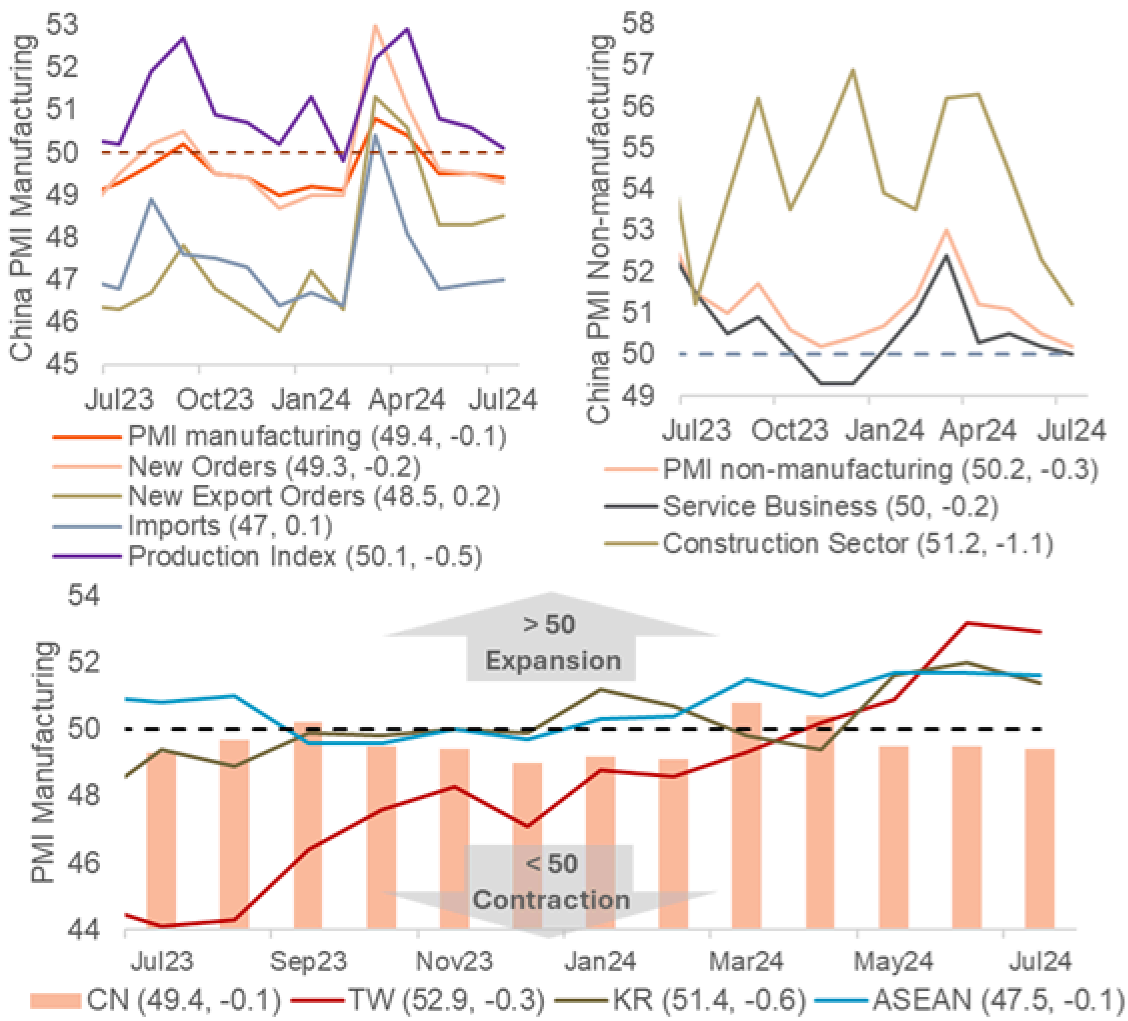
The sentiment within services sectors is waning, with the China non-manufacturing PMI reaching a new low for the year at 50.2 (-0.2) and matching the lows of November 2023. The fast pace of the weakening of sentiment, with services business activities declining to neutral (50) from a high of 52.4 in March 2024, and construction business activities at 51.2, the lowest level since July 2024, is a worrying sign (see Exhibit #1). Such momentum, if it continues, might result in a simultaneous contraction in manufacturing and non-manufacturing sectors for the first time since December 2022.

That said, the regional economy exhibited incredible resilience, brushing aside the drag from China. Manufacturing PMI for ASEAN countries, (including Malaysia, the Philippines, Singapore, Indonesia and Thailand) has been supported by the recovery of the tourism sector, while the rebound in Taiwan and South Korea was helped by the boom in semiconductors and chips.

Looking ahead, our view is that APAC economic recovery momentum will continue, and it might get a capital inflow-related boost if we see a sustained soft US dollar or strong APAC currencies.

On China, we warn against extrapolating a downside macro risk. We believe a stabilization phase is near, supported by multiple regulatory reforms, credit and monetary policy easing and pledges of fiscal policy support in H2 2024. The latest Politburo statement has made clear that emphasis should be placed on boosting consumption to expand domestic demand, proactive fiscal policy and greater self-reliance and strength in science and technology and more.

Exhibit #1: Export recovery gains momentum

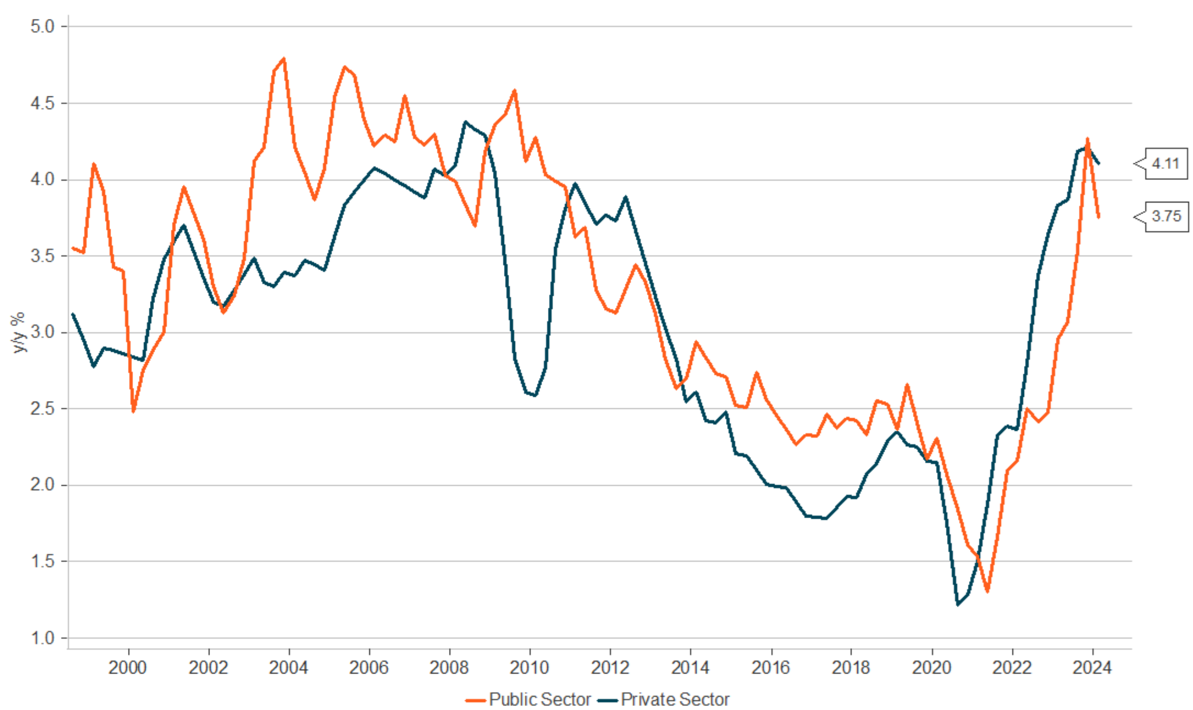


Source: BNY, Bloomberg L.P.

The Reserve Bank of Australia will also be closely watching upcoming developments in China, especially on news regarding investment growth, which traditionally helps the Australian economy. We don't expect any change in the RBA's cash rate at this meeting. The recent round of soft price data in Australia has encouraged markets to price in a policy pivot, whereas previously the RBA had been one of the few developed market central banks in a position to contemplate a hike. However, most of the considerations will be domestic factors, which had underpinned upside price risks in the Australian economy.

We have always felt that the bar for a hike for any G10 economy would be high, especially now that the Fed is moving in the opposite direction. The Bank of England cut this week was another sign that central banks are now willing to move, even with services inflation – and implicitly wage growth – running at relatively high levels. In Australia, the risks are similar regarding moving too early. Wage inflation in both the public and private sector are still running at very high levels relative to history (Exhibit #2) and it will take time before restrictive policy feeds through into Australian wages, if at all. Similar to the UK, there are productivity matters to grapple with and the lack of divergence between public and private sector wage growth suggests that the drag is broad-based. Unlike the BoE, the RBA will have better labor market data to analyze so the “precautionary” argument is much weaker. We believe that the central bank will need to see at least a quarter’s worth of confirmed declines in wage growth before there is a window to act. This does not rule out easing this year, which already represents a forward shift in policy expectations compared to previous guidance. Consequently, the current caution in RBA pricing (60% chance of one cut by year-end) seems appropriate.

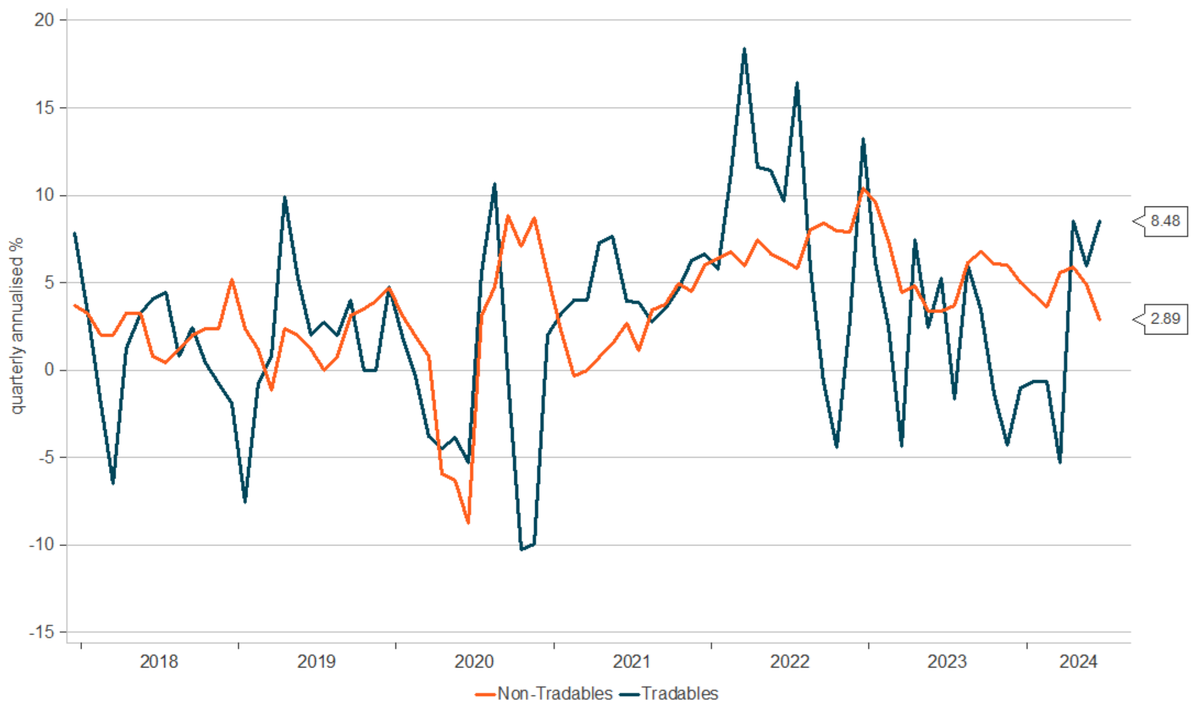
Exhibit #2: Wage growth continues to hold at highs



Source: BNY, Bloomberg L.P.

Furthermore, the decomposition of inflation (Exhibit #3) also risks being counterproductive. On a quarterly annualized basis, current non-tradables inflation is notably sticky at just about 3% annualized. Like services inflation, the strongest input will be in the form of wage growth. At present this is no confirmation of any material downturn, even on a sequential basis. Meanwhile, the current level of the AUD is clearly contributing to pass-through, as tradables inflation has risen sharply to close to 8.5% on a quarterly annualized basis. The rebound seen over the past few months has undone much of the tradables disinflation seen through the past year. Pass-through aside, this also indicates that demand weakness is also not as pronounced and calls into question the reasoning for easing. As such, not only does premature easing risk setting back efforts to slow wage growth, but a subsequently weaker AUD may push up tradable inflation materially and upside risk to inflation expectations through the goods channel, which would inevitably feed into wage-setting. Fed easing will likely help valuations for AUD and peers, but this also means the RBA should wait until September when the Fed is expected to ease and also set out its path.

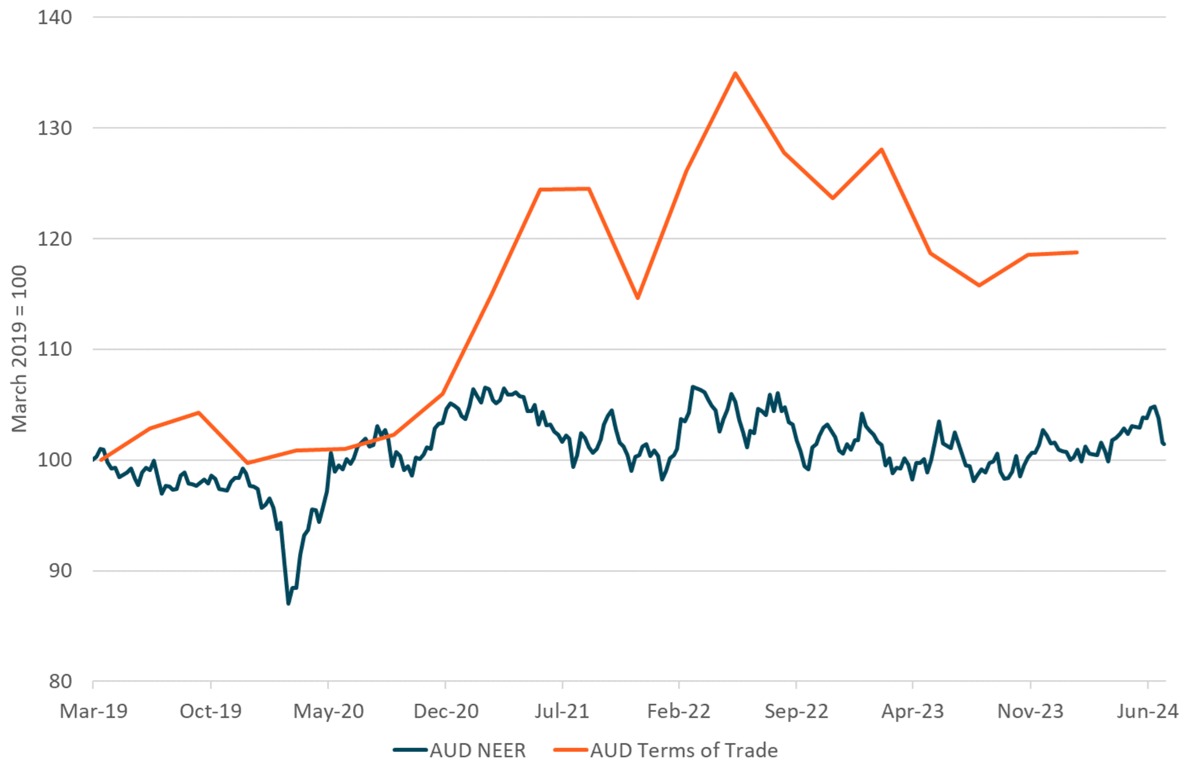
Exhibit #3: Non-tradables inflation clearly dipping



Source: BNY, Bloomberg L.P.

In a tradables inflation context, the RBA would probably welcome any form of Chinese growth impulse, which could help Australia's terms of trade. Yet, we would not raise expectations in this respect as the communication from Beijing is clearly geared toward boosting domestic consumption and lifting inflation expectations. Australia's terms of trade have diverged from valuations (Exhibit #4) in recent years, and for the most part commodity prices have not been justified by underlying demand dynamics. However, we also believe that as part of China's easing process specified above, the renminbi will not be in a position to strengthen, which in turn should help anchor AUD's nominal effective exchange rate (NEER) and start to limit tradables inflation. Improvement in AUD valuations will help pave the way for rate cuts and there is no reason for the RBA to disrupt the process.

Exhibit #4: Terms of trade and NEER still misaligned



Source: BNY, Bloomberg L.P.

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Please direct questions or comments to: iFlow@BNY.com

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