Highlights

It is all about the escalation of trade war. Market is still waiting for two things including China's retaliation package and US's detailed plan about tariff on the remaining US$325 billion Chinese products. Change is the only constant in trade talk unfortunately. Market will continue to be driven by headline news going forwards.

Let's brainstorm, there are three possible options China may consider to counter the impact of tariff including RMB depreciation, monetary easing and fiscal stimulus. We think China is unlikely to engineer 25% depreciation to counter the impact of tariff as the cost of capital outflows amid the shrinking current account surplus may outweigh the benefit of supporting export. This also suggests that monetary easing and fisical stimulus will play a bigger role.

On economic data, April economic data softened slightly, but not significant enough to trigger the renewed concern about the slowdown. Meanwhile, China's inflation continued to trend higher driven by pork prices and travel costs in April. However, given the rise of pork prices remain controlled; we see low risk of overshooting of inflation. As such, the latest data is unlikely to be the constraints to China's policy dynamic.

Overall, we think China's recent fine-tuning of monetary policy back to neutral will be under test again. The chance of easing monetary policy is getting higher. This may be supportive of liquidity and bond in the near term.

In **Hong Kong**, retail sales dropped for the second straight month by 0.2% yoy in Mar despite that visitor arrivals increased strongly by 17.3% yoy during the same month. Zooming in, the sales of food as well as goods in supermarket and department stores all increased, owing to the tight labor market, wealth effect from stock and property market rally, a stable RMB and China's economic stabilization. Nonetheless, the sales of clothing and footwear, consumer durable goods, as well as jewelry and watches all continued to drop as domestic and visitor consumption remained cautious due to external headwinds. In conclusion, we expect retail sales to grow only marginally by 1% this year. Should US-China trade tensions escalate, consumer sentiments may take a hard hit and weigh further on the retail sector. On the housing market front, it continued to regain momentum owing to the eased concerns about higher borrowing costs, wealth effect from stock market rally and the renewed fret about decreased home affordability. These favorable factors may allow housing market rally to sustain into the coming months. Still, we believe that the upside for housing market will be capped in the near term due to cautious sentiments on global headwinds, increasing short-term supply, limited downside for mortgage rates and the risk of government launching new cooling measures. As such, we revise our forecast for housing price growth from -6.5% yoy to 8% yoy for 2019. In **Macau,** property market rebounded in Mar and may remain supported in the near term by wealth effect, developers' sweeteners, eased concerns about higher interest rates and the measure supporting first-home local buyers. However, the market's upside may be capped by external headwinds, the housing cooling measures and the diminishing effect of supportive measure.

Key Events and Market Talk	
Facts	**OCBC Opinions**
▪ The USTR raised the additional tariff on US$200 billion Chinese products to 25% from 10% on Friday as planned, marking the escalation of the trade war.	▪ This does not mean the end of US-China trade talk though the talk was shadowed by the rise of tariff. Both sides are still trying to narrow the differences but failed to reach any conclusion last Friday. The negotiation has met the obstacles as China has stepped up its defence of its basic principles. ▪ Since last December, the relationship between US and China has improved steadily albeit gradually, the sudden unexpected collapse ahead of the final step to ink a 150-page long trade deal caught market by surprise. ▪ With more information being unveiled by both sides, it is getting clearer that there are possible four core discrepancies yet to be agreed. ▪ The whole drama started from 3rd May according to the US side after the US received the modified version of trade deal from its Chinese counterparty omitting the part of change of laws as demanded by the US side. This was read by Lighthizer as backtracking of previous agreements, which led to Trump's twitter on 5 May. ▪ The initial hope that Trump's twitter may be part of his

	negotiating strategy proved to be wrong as it was mainly the reflection of the anger from the US side on the slow progress of trade talk. In the hindsight, market has underestimated the discrepancies between both sides. Based on the current clues from the both sides, we think there are four core concerns for the upcoming negotiations. ▪ First, the US wants to secure China's regulatory commitment via the change of law endorsed by National People's Congress rather than via the guidance from the State Council or respective ministries. This may touch China's red line. As mentioned by Vice Premier Liu He last week, China wants a balanced text of the deal to ensure the dignity of both nations. The different understanding about the dignity may be one of the key hurdles for the negotiation. ▪ Second, China wants to remove the entire existing additional tariff should a deal be reached. However, it seems that Trump administration is unwilling to compromise. Trump has repeatedly shows his satisfactory about the increasing tax receivable via the tariff. He even argues that US may use the money from tariff to purchase agriculture products from US farmers who were affected the trade war. ▪ Third, the aggressive enforcement mechanism, which may allow the US to re-impose tariff unilaterally should China fail to comply with the trade deal, may also be unacceptable to Chinese government. ▪ Fourth, the possible increase of targets for Chinese purchase may also contribute to the stall of trade talk. China's Vice Premier Liu He said that the amount of purchase should be in line with reality. ▪ With the new tariff being imposed, the marginal impact of tariff on Chinese economy is likely to be significant as not may Chinese exporters are able to handle 25% tariff as compared to 10% tariff due to their thin margin. However, the impact on the economy remains uncertain as it depends on which side will eventually be responsible for those tariffs. It is not necessary that the tariff will be paid by Chinese manufacturers.
▪ China's liquidity turned flush again last week with the overnight repo rate fell to below 1.5% amid the concern about the trade war 2.0.	▪ China's recent fine-tuning of monetary policy back to neutral was under test again. In order to counter the rise of tariff, there are three options China may consider including RMB depreciation, monetary easing and fiscal stimulus. As we argued that China is unlikely to use RMB as tool to counter the trade war, the expectation on monetary easing and fiscal stimulus heightens again. This may be supportive of liquidity.
▪ Hong Kong's exchange funds gained a record quarterly returns of HK$120.9 billion in 1Q 2019.	▪ As the US dollar depreciated against certain currencies in 1Q, the exchange funds exhibited foreign exchange gains of HK$13.5 billion, reversing the previous quarter's loss. Besides, local and overseas stock investments respectively recorded huge returns of HK$20.8 billion and HK$49.9 billion, mainly due to the broad-based stock market rally on the back of trade war optimism, major central banks' dovish tone and China's stimulus. In the meantime, with more and more banks shifting to easing bias, adding on the lingering global headwinds and the increasing concerns about global economic outlook, global bond markets continued to rebound and allowed the HKMA's bond investments to gain HK$36.7 billion. ▪ Moving forward, the performance of exchange funds in the

	coming quarters remains uncertain. At this juncture, we believe that the upside for global stock market may be capped as market has fully priced in the expectations of major central banks' easing bias but not yet well priced in the possible escalation in trade war and further slowdown in global growth. In contrast, bond market's bull run may continue should global growth remains on a downtrend and trade tensions escalate. Elsewhere, we expect the US dollar to remain resilient in the coming quarter owing to the yield differential, solid domestic growth as well as the safe-haven demand. This will in turn limit or even revert the gain from foreign exchange. In conclusion, exchange funds may not achieve such a strong return in the coming quarters as stock market and bond market will unlikely to thrive simultaneously given global uncertainties. Still, we expect exchange funds to record moderate gains this year.

Key Economic News	
Facts	**OCBC Opinions**
▪ Both China's new Yuan loan and aggregate social financing were weaker than expectation in April. ▪ China's M2 decelerated slightly to 8.5% from 8.6% previously.	▪ The slower than expected on-balance sheet credit expansion in April was mainly the result of the frontloading of lending in the first quarter. Meanwhile, the shift of China's monetary policy from universal easing to targeted easing may also cap bank's appetite to lend. ▪ Off-balance sheet lending fell by CNY142.7 billion in April mainly due to the shrink of undiscounted bill. Corporate bond issuance and local government borrowing remain the key support to China's aggregate social financing. The net corporate bond issuance increased by CNY357.4 billion while the issuance of local government special bond rose by CNY167.9 billion. However, the rising bond yields in April may dampen the sentiment on bond issuance in the coming months. ▪ On the positive note, China's fiscal deposit increased by CNY534.7 billion, lower than last year's level, despite the tax payment season. The lower than expected fiscal deposit signals that a more proactive fiscal policy, which continue to support China's growth.
▪ China's CPI grew by 2.5% yoy in April, in line with expectation. However, PPI accelerated by more than expected to 0.9% from 0.4%.	▪ CPI increased by 0.1% mom driven by higher pork prices, which rose by 1.6% mom. Meanwhile, core CPI also rose by 0.1% mom due to higher travel package ahead of Labour day long weekend. Despite the concerns about the swine flu, it seems that the rise of pork prices remains controllable. As such, we expect May CPI to inch higher modestly to around 2.6% in May. Overall, we expect China's CPI to stay below government's target of 3%.
▪ China's export fell by 2.7% yoy in dollar term in April while import unexpectedly improved up by 4% yoy. ▪ As a result of stronger import, China's trade balance fell strongly to US$13.84 billion.	▪ The decline of export in April was in line with weak growth in Europe and the weak demand from Canton Fair. With the escalation of US-China trade war in May and the high base effect in the second half, we think China's export growth is likely to remain weak.
▪ HK's property market continued to gain growth traction with secondary housing prices rising for the third consecutive month by 2.9% mom in March. Housing transaction volume and value surged by 17.7% yoy and 13.4% yoy respectively to 7822 deals	▪ Three factors including eased concerns about higher borrowing costs, positive wealth effect from stock market rally and renewed fears of decreased housing affordability continued to release pent-up demand and boost the housing market. These favorable factors may allow housing market

(highest since Sep 2016) and HK$70.1 billion (highest since Nov 2007) in April.	rally to sustain into the coming months. ▪ Still, we believe that the upside for housing market will be capped in the near term due to several reasons. First, investor sentiment may be cautious amid global headwinds such as the renewed US-China trade tensions. Second, there will be around 5000 units of public housing available in mid-2019 while property developers may bring forward the launch of new projects to avoid the upcoming vacancy tax. This suggests increasing short-term supply. Third, even though the chance of prime rate hike is slim this year, the downside for mortgage rates seems limited due to the decrease in aggregate balance. One-month HIBOR has hovered above 1.5% since mid-March. Fourth, if property market reaches new high in the coming months, the possibility of regulators unveiling new cooling measures cannot be ruled out. Taken all together, we revise our forecast for housing price growth from -6.5% yoy to 8% yoy for 2019. ▪ Nevertheless, in the long term, the property market may not have much room for correction due to the expectedly low supply. On the one hand, the government has promised to adjust the public to private housing supply ratio from 6:4 to 7:3. This raises concerns that long-term supply of private housing will decrease accordingly. On the other hand, the vacancy tax may impede property developers from aggressively developing new homes. Housing completion and housing start dropped by 17% yoy and 58.9% yoy in 1Q 2019. The government also expects that only 13,700 units of private housing (-5% yoy) will be available in the coming year.
▪ HK's retail sales dropped for the second straight month by 0.2% yoy in Mar despite that visitor arrivals increased strongly by 17.3% yoy during the same period.	▪ On a positive note, the performance of the retail sector has improved from the first two months when retail sales dropped by 1.6% yoy. Zooming in, the sales of food, alcoholic drinks and tobacco increased by 3.6% after shrinking 1.1% in the prior two months. Besides, the growth in the sales of goods in supermarket and department stores accelerated from 1.2% yoy and 4.2% yoy in Jan-Feb to 3.3% yoy and 5.0% yoy in Mar respectively. This suggests that part of the retail sector has regained momentum thanks to the tight labor market, wealth effect from stock and property market rally, a stable RMB and China's economic stabilization. Nevertheless, other part of the retail sector continued to show disappointing performance. The sales of clothing and footwear, consumer durable goods, as well as jewelry and watches continued to drop by 1.3% yoy, 9.9% yoy and 2.6% yoy respectively in Mar. This indicates that domestic and visitor consumption remained cautious due to external headwinds such as the faltering global growth outlook. Taken all together, we believe that the mixed picture of the retail sector will persist into the coming months. Retail sales are expected to grow only marginally by 1% yoy this year. Should US-China trade tensions escalate, consumer sentiments may take a hard hit and weigh further on the retail sector.
▪ Macau's average housing price rose by 12% mom or 10.9% yoy to MOP110,424/square meter in Mar. During the same month, housing transaction volume rose by 83.3% mom to 572 deals while approved new residential mortgage loans surged by 85.8% mom to MOP3.38 billion.	▪ The rebound in housing market was mainly due to the abated seasonality, the positive wealth effect from stock market rally, developers' sweeteners, eased concerns about higher interest rates and the measure supporting first-home local buyers (took up 82.2% of total local buyers in Mar). ▪ Nevertheless, on a year-on-year basis, housing transaction

	volume and approved new residential mortgage loans continued to drop by 11.2% yoy and 44.5% yoy in Mar. This signals that investor sentiment remained cautious against faltering economic growth outlook. Also, the housing control measures continued to curb speculative demand. The percentage share of local buyers holding more than one residential property in total local buyers stayed low at 4.2%. ▪ Moving ahead, though the lowered probability of rate hike, the supportive measures and limited supply (housing completion and start decreased by 86% yoy and 89% yoy in 1Q) could continue to support the housing market, the market's upside may be capped by several unfavorable factors. First, external headwinds including global economic slowdown and renewed US-China trade tensions may dent investor sentiment. Second, the housing cooling measures could continue to take effect. Third, the effect of measures supporting first-home local buyers may subside gradually. All in all, we expect total housing transaction volume to decrease year-on-year in 2019. Average housing price will likely hover in the range of MOP100,000/square meter to MOP110,000/square meter.

RMB	
Facts	**OCBC Opinions**
▪ RMB weakened significantly last week as the result of escalation of trade war. RMB index slipped to 94.78 last Friday and is expected to weaken further.	▪ We think China is unlikely to engineer 25% depreciation to counter the impact of tariff as the cost of capital outflows amid the shrinking current account surplus may outweigh the benefit of supporting export. The pressure on RMB depreciation may depend on three near-term factors including the size of China's retaliation package, US's plan to impose tariff on the remaining US$325 billion products and market's assessment on whether the setback is temporary or not.

OCBC Greater China research

Tommy Xie
Xied@ocbc.com

Carie Li
Carierli@ocbcwh.com

Co.Reg.no.:193200032W