Global Macroeconomics | 4Q19

Global macro divergence

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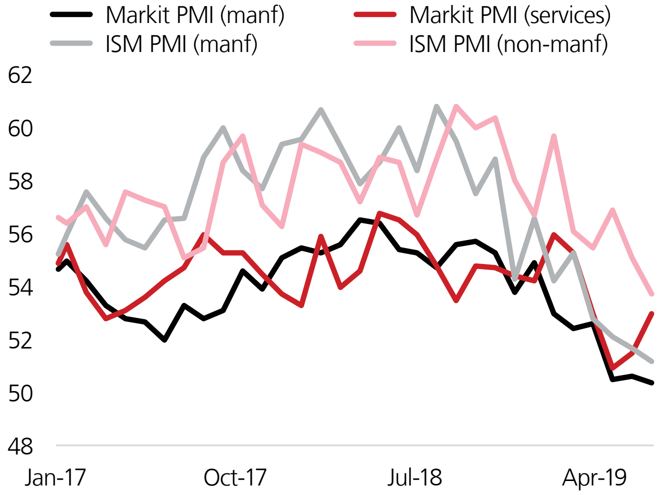
Data from a wide range of economies (China to Germany to Singapore) suggest that global trade and manufacturing are undergoing a torrid phase. Thanks to the escalating trade war, demand for both electronics and auto are weak and overall investment sentiment is poor. Recent stress from Argentina suggests that a low rates environment is not necessarily a panacea for EM – a period of heightened risk aversion followed by a flight-to-safety toward safe assets could pose difficulties for economies characterised by persistent Current Account deficits. Another case is the recent widening EM high yield credit spreads, which show that the rally in government bonds is not allaying concerns about the private sector's outlook.

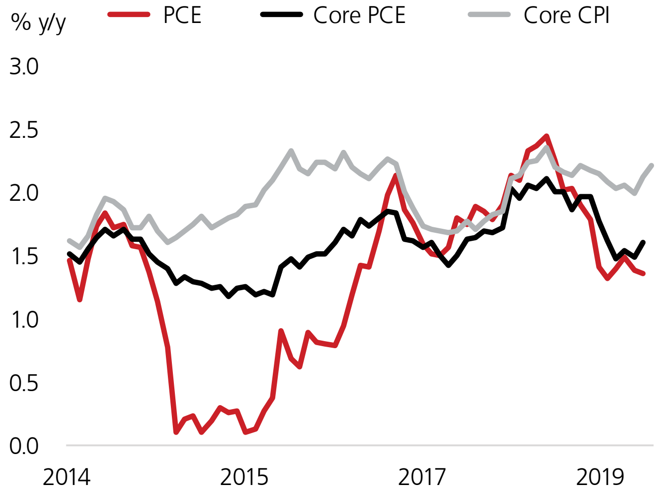
The US, in contrast, is holding up rather well amid this gloom and doom. Dataflow through September supports the view that economic momentum is comfortably above 2% (annualised GDP growth) with the outlook for retail sales, housing, wages, and jobs looking broadly favourable.

Figure 1: PMIs show some slowdown



Sources: CEIC, DBS

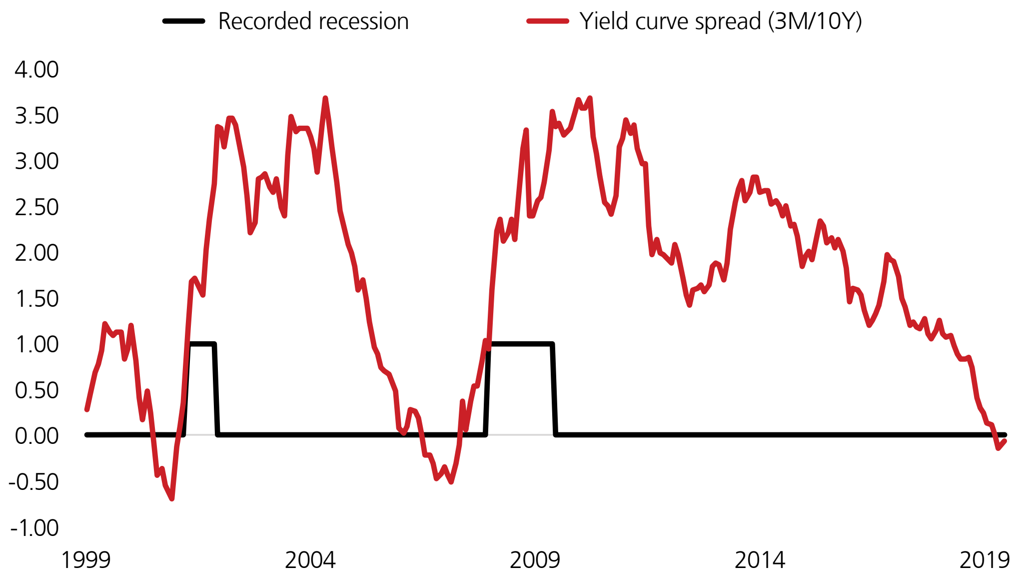
Figure 2: Inflation is benign, but not very low



Source: CEIC, DBS

But, can this bifurcation of a tranquil US vs a slowing rest of the world last? We are doubtful. The risk is that a major point of divergence between the Federal Reserve and global markets occurs in 4Q19. Affected by a progressive slowdown in China and the EU, whiplashed by the trade war, concerned about various pockets of geopolitical flashpoints, and finally, alarmed by the sharp ongoing slowdown in the global auto and electronics sales, DM bond yields have declined sharply and many central banks have started cutting rates. But as far as the US is concerned, the Fed sees steady growth of GDP, wages, and jobs, as well as stable financial markets and moderate inflation. From that vantage point and given its mandate, Fed officials are progressively struggling to live up to market expectations.

Figure 3: Yield curve has inverted, but recession is not imminent



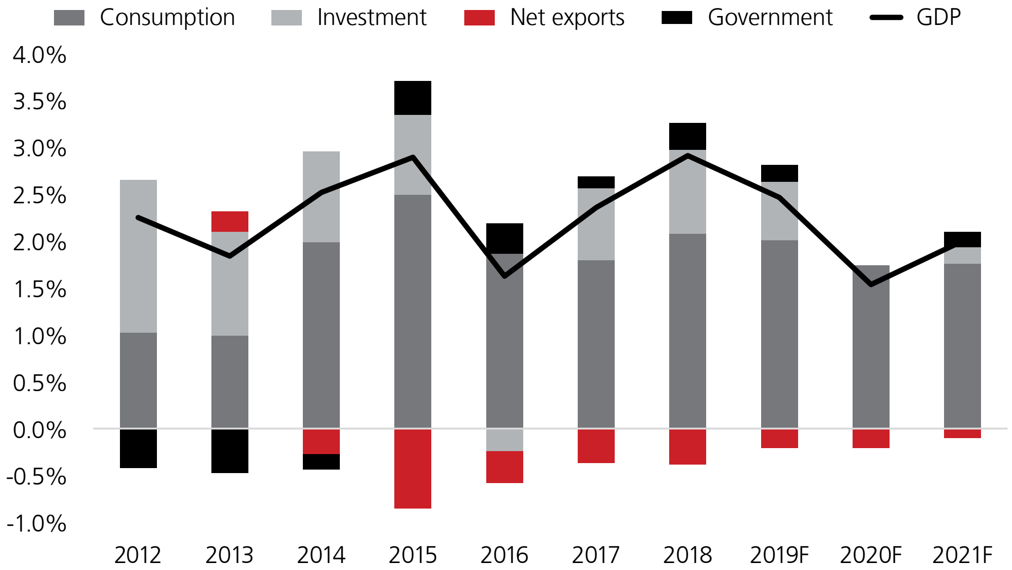
Sources: CEIC, DBS

Additionally, three stress points are emerging:

a) First, as China's economy slows and risks its production being subject to sanctions, global multinationals are seeing their sales and profits to the world's most populous nation weaken.
b) Second, investment outlook has turned cloudy as little has been resolved with respect to various ongoing trade and currency conflicts (US-China, US-Europe, US-Japan, Japan-South Korea, and more). This caused much angst among investors and sentiment has considerably worsened.
c) Third, the slowdown in global manufacturing and trade is beginning to weigh on US business confidence. The agriculture sector, especially soybean producers, is feeling the brunt of the trade war, whereas electronics manufacturers are looking at a potential loss of demand from China and probable headwinds to sales from higher tariffs. In recent months, US industrial production has also joined the global slowdown trend.

We have long expected an investment slowdown which would lead to an economic correction in the US in 2020. Short of a dramatic improvement in trade prospects, conditions are aligning for that. In our forecast, we see investment slumping next year, no fiscal stimulus in progress, and slightly softer consumption which is sufficient to take growth to a below-trend of 1.5%.

Figure 4: A slowdown scenario builds around weak contribution from investment and fiscal



Sources: CEIC, DBS

Eurozone

Momentum to ease for rest of 2019

In 2Q19, the Eurozone economy expanded at 0.2% q/q, half the pace of 1Q19. Germany emerged as the biggest drag with a contraction of -0.1% q/q while other core economies decelerated from a more resilient start early this year.

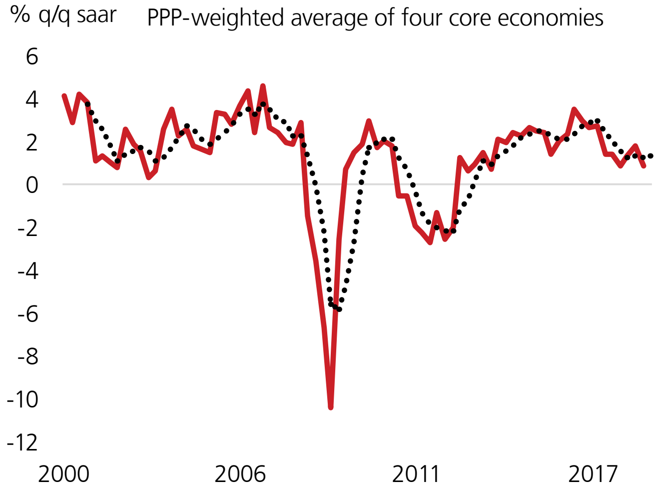
The divergence between more resilient domestic drivers (primarily consumption) vs weakness in external trade is likely to persist. More external indicators will stay under pressure as the US-China trade conflict hurts global growth, affecting Eurozone by extension. It is most evident in the industrial sector, with overall production declining -2.4% y/y in June 2019, continuing the lacklustre trend since 1H18.

Germany is under watch as recession risks rise. Business surveys have been softening, weighed by car industry woes and weak capital goods output, reflecting poor demand from China and other Asian markets. EUR depreciation on bilateral terms (-10% vs USD since early-2018) and effective exchange rate basis have been unable to provide enough fillip.

Labour market strength will support consumption spending, but its persistence might wane as the unemployment rate bottoms out. Weakness in industrial activity together with pass-through to services might pose a risk to household spending in 2H19 and the next year. Given these indications, we maintain our growth forecast at 1.2% y/y for this year, with 20-30 bps downside risk to our 2020 GDP forecast of 1.5%.

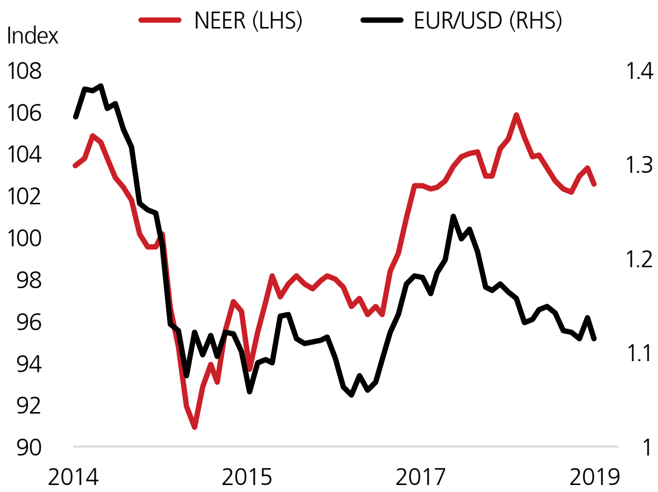
Inflation dynamics are benign, with a sharper correction in inflationary expectations questioning the credibility of the ECB's dovish guidance. Headline inflation is likely to hover around 1% for the rest of the year as oil remains stable. Core inflation will be a shade lower, suggesting that a threat or breach of the 2% inflation target is not on the horizon.

Figure 5: Growth has slowed down across four core economies



Source: CEIC, DBS

Figure 6: EUR exchange has depreciated on bilateral and effective exchange rate basis



Source: CEIC, DBS

The ECB will prefer to act pre-emptively

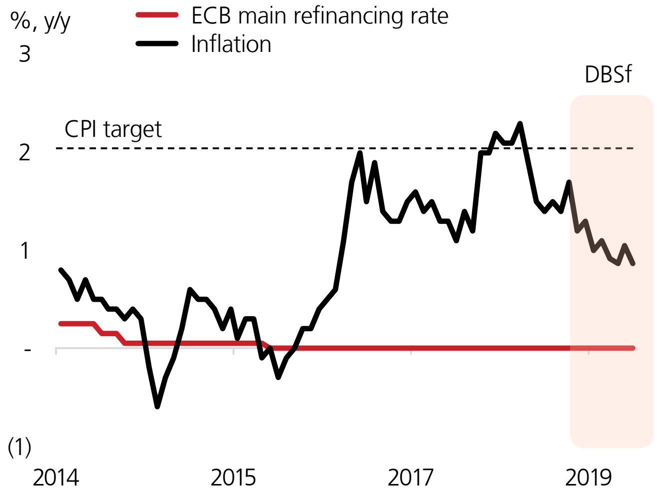
The ECB will prefer to act pre-emptively, addressing low inflation and near-stagnate growth. Apart from the trade-related uncertainty, fallout from political instability in Italy and Brexit-led volatility will also keep policymakers on tenterhooks.

In September, the ECB pushed the deposit facility rate deeper into negative territory (accompanied by tiering mechanism), realigned LTRO III pricing, and unveiled a EUR20b per month asset purchase scheme. The open-ended nature of QE might need a review of investment thresholds within a year. If slowdown risks deepen, the central bank might widen the assets pool to senior bank bonds, equity, and corporate bonds. Former IMF Head Christine Lagarde will become the ECB president when incumbent chief Mario Draghi's term ceases in late-October. While monetary policy does much of the heavy lifting, calls for concurrent fiscal loosening is also rising.

Figure 7: Inflationary expectations have corrected sharply

Source: CEIC, DBS

Figure 8: Sub-target inflation will keep the ECB dovish



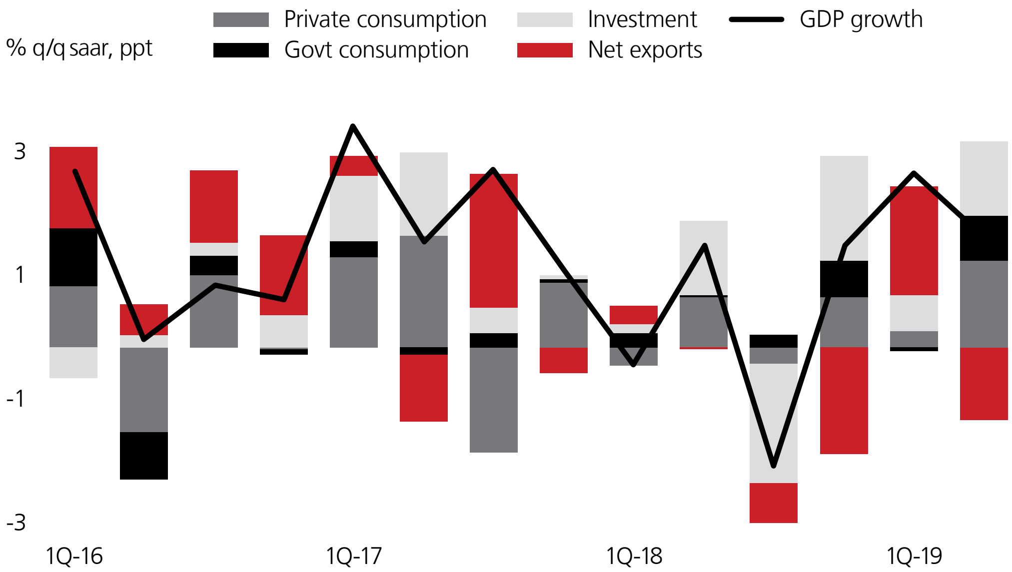
Source: CEIC, DBS

Japan

Our 2019 GDP forecast remains unchanged at 0.7%, despite a better-than-expected 1H19

Japan's economy has fared better than expected so far this year, with GDP growth averaging 1.1% y/y in 1H19. However, taking into account a series of external and domestic challenges in 2H19, we maintain the full-year growth forecast at 0.7%.

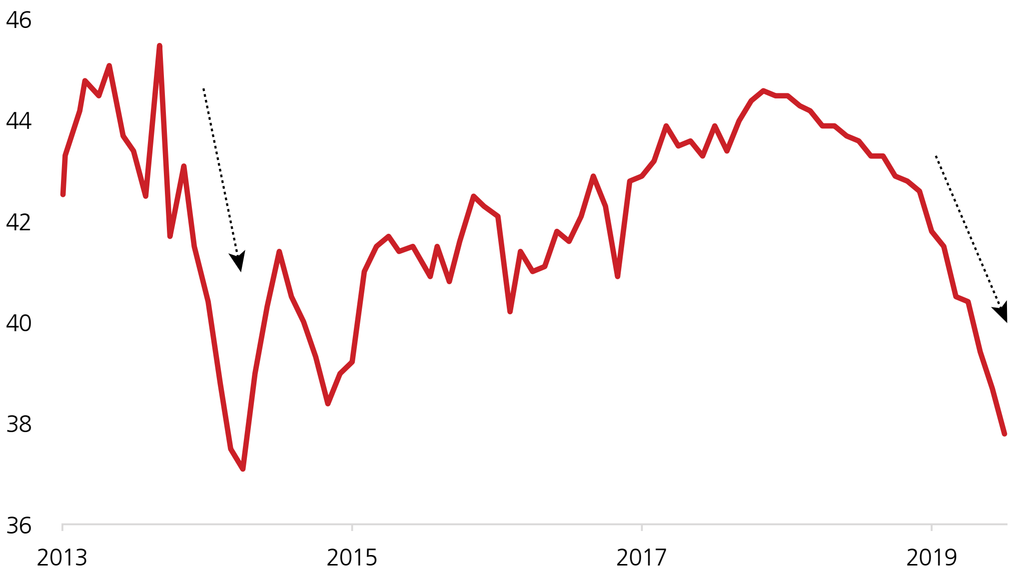
Figure 9: GDP growth bolstered by domestic demand



Source: CEIC, DBS

The planned consumption tax hike in October (from 8% to 10%) may trigger a one-off decline in domestic demand. At present, rush demand ahead of the tax hike is not clearly in sight, suggesting that demand may not plunge thereafter. But consumer confidence has been falling sharply, identical to the pattern seen prior to the previous consumption tax hike in 2014, which is not a good sign for the 2H19 post-tax hike outlook.

Figure 10: Consumer confidence falling sharply, like in 2014



Source: CEIC, DBS

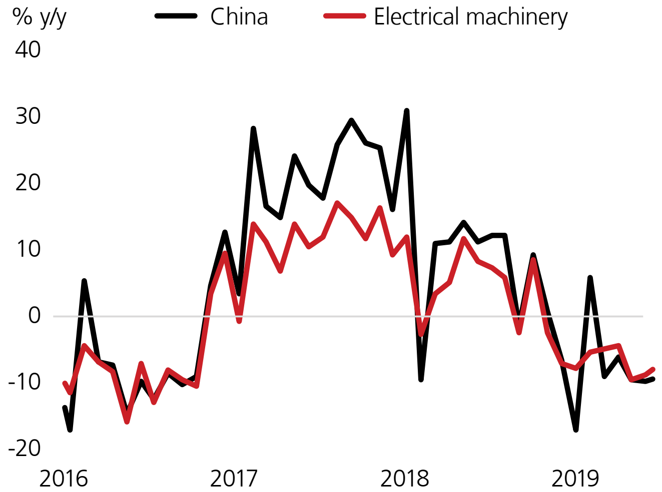
There are more headwinds on the external front. First, the deteriorating Japan-South Korea relations. Japan's export controls imposed on South Korea are likely to slow production activities in the latter's semiconductor and display screen sectors, which would, in turn, hurt Japanese electronics producers. South Korea's retaliatory measures, such as boycotts of Japanese goods and travel, could hurt Japan more directly as South Korea is Japan's third-largest export destination and second-largest tourism market.

Second, the ever-escalating US-China trade war. The US's decision to impose tariffs on USD300b of Chinese imports carries the risk of disrupting the region's electronics supply chains. Japan's exports to China and its electronics products' export volumes have been falling continuously so far this year, a result of China's slowdown as well as the downturn in the global technology sector. Things may worsen in 2H19-2020.

Third, uncertainties surrounding US-Japan trade relations. The US is set to impose tariffs on automobile imports from its trade partners by November. The outcome of the ongoing trade negotiations with the US will determine if Japan is exempted.

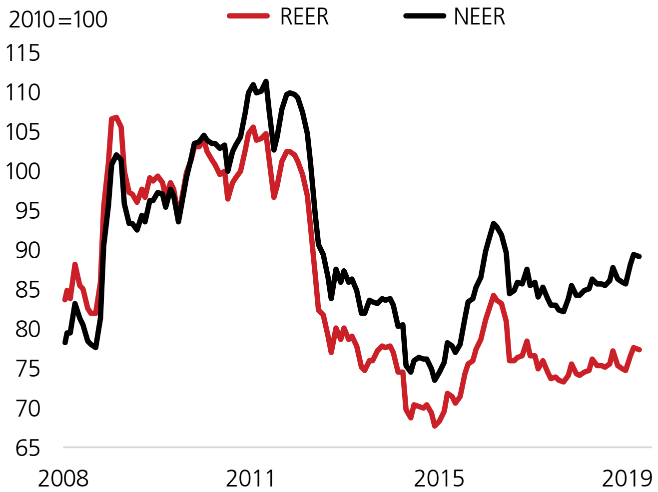
In addition, the Japanese yen could face pressure to appreciate against the backdrop of the Fed's and the ECB's monetary easing, and the rise in global geopolitical uncertainties. A sharp, one-way rise in the yen would be a warranted concern for policymakers, as it erodes exporters' corporate earnings, hurts capex/wage outlook, and notably, dampens inflation expectations.

Figure 11: Exports to China and electronics exports on the decline



Source: CEIC, DBS

Figure 12: JPY effective exchange rate appreciated



Source: CEIC, DBS

Rising chances of BOJ easing

The chances of the BOJ easing for the rest of this year are on the rise. Possible options would include strengthening forward guidance, widening the range of the 10-year yield band, and directly cutting the short-term policy rate (together with measures to mitigate unfavourable implications on banks' profits, e.g. offering negative lending rates to banks and reducing the portion of banks' reserves subject to negative deposit rates).

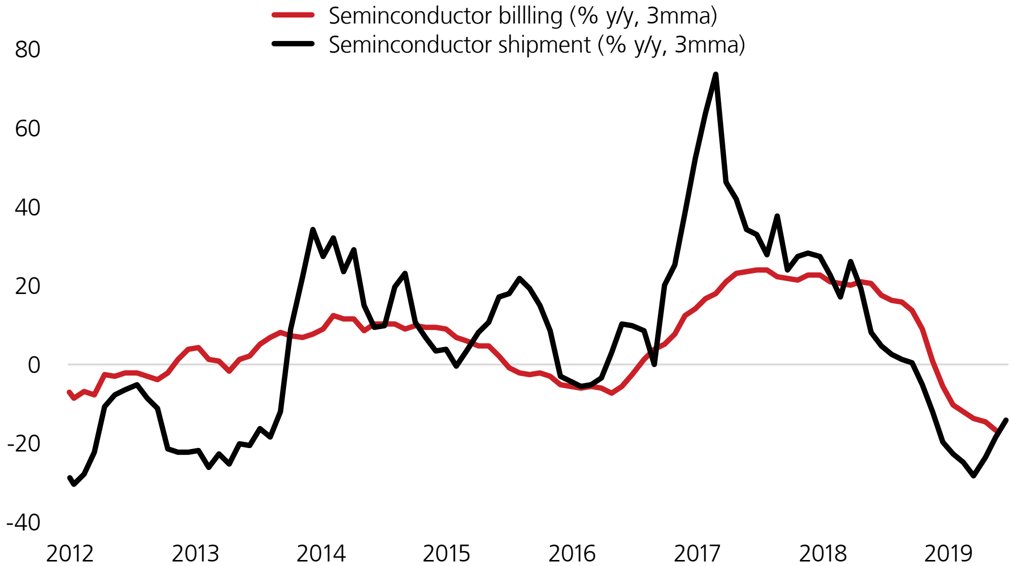
Asia

Trade war and China slowdown hurting Singapore and South Korea the most

Singapore and South Korea appear to be bearing the largest burden from the trade wars and China's slowdown. Singapore's economy contracted 3.3% q/q SAAR in 2Q19. A challenging global economic climate, coupled with the ongoing US-China trade war, are key drivers behind the subpar growth performance. Against the backdrop of a grim economic outlook, negative output gap, and benign inflation, a change in the parameter of the policy band in October is pretty much cast in stone. The SGD NEER is gradually shifting toward the mid-point of the policy band, suggesting that adjustment in monetary policy is in the offing.

The key question is the shape and form of the upcoming policy easing, and there are a few options available for the authority. We reckon that the MAS will moderate the slope of the SGD NEER policy band in a calibrated manner. Though there is room for a more pre-emptive and aggressive monetary policy action – such as shifting toward a zero-appreciation stance – there are several considerations for that to happen. For example, the economy may have to dip into a technical recession in 3Q19 and risk entering an all-out recession in 2020 to warrant such an action; or global outlook will have to deteriorate sharply in the coming months, thereby prompting global central banks to ease monetary policies more aggressively. Unless these factors pan out in the coming months, the MAS can still afford to take a more calibrated approach in managing its monetary policy. Furthermore, the fact that the government has yet to announce any short-term stimulus package suggests that authorities are not in crisis-management mode yet.

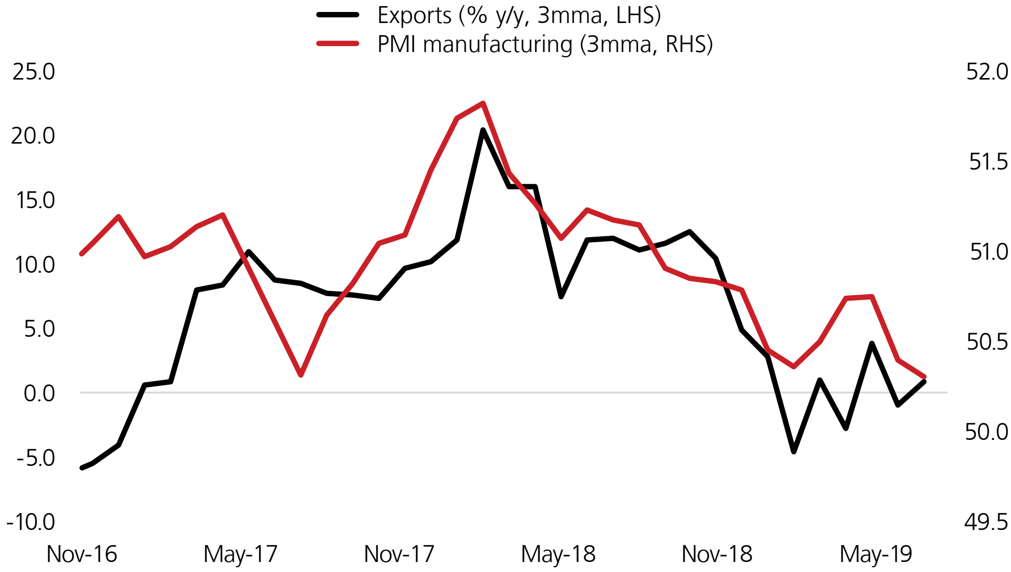
Figure 13: Waiting for a turnaround in global semiconductor demand



Sources: CEIC, DBS

Meanwhile, South Korea is also facing considerably weaker growth and inflation than previously expected. Both the manufacturing and construction sectors have entered a recession in the context of global demand weakness, technology sector downturn, property market slowdown, and US-China trade tensions. New headwinds have also risen from the recent escalation in Japan-Korea trade disputes. Japan's move to curb the exports of high-tech materials to South Korea could disrupt production activities among South Korean semiconductor and flat panel display companies, as they highly rely on Japan for the supply of crucial materials. Given the dovish Fed/ECB and the fall in DM yields into negative territory, the low yields of KRW assets are no longer a distinct disadvantage. In line with our forecast of two 25 bps Fed rate cuts in 2H19, we think the BOK also has room to deliver one more cut toward the end of this year and bring the total magnitude of rate cuts to 50 bps.

Figure 14: EM Asia's (PPP-weighted) exports and PMI



Sources: CEIC, DBS

As for China, the economy is clearly still trending downward though much of the slowdown observed hitherto is within expectation. The headwinds going forward remain strong. Relocation of manufacturers to Southeast Asia has already become a fad. The trade war's negative impact will continue to inflict Southern China the most, given the relative higher export-to-GDP ratio than the inner parts of the country. FDI is also on a downtrend. The confluence of such factors negatively impact consumer/investment confidence before eventually translating into lower property and equity prices.

At this juncture, the current macroeconomic situation is increasingly a case of retreating aggregate demand. It is important to buttress domestic demand by investment. Fiscal policy must be much more proactive – there must be deep considerations for the long-term and an emphasis on technological renovations and productivity enhancement. The aim is to generate sustainable new growth areas. On the other hand, the central bank will have to cut benchmark interest rates and the RRR to pre-empt the escalating risks of deflation. Our Nowcasting model shows growth will slow to 6% in 3Q19, driven by the easing in industrial production, loans, and retail sales growth.

Oil: Slowing demand vs geopolitics-led supply shock

Heightened trade war tensions have queered the pitch for oil

Oil prices are in a tug-of-war between slowing demand – that has a longer-term effect from the ongoing US-China trade war – and potential short-term supply shock from the intensifying geopolitical tensions in the Middle East. Brent fell to USD60s/bbl amid an ever-escalating US-China trade war, before recovering to above USD65/bbl following the massive drone attacks on Saudi plants that disrupted c.5% of global supply in mid-September.

Oil demand growth lowered. Our previous forecast for FY19/20's annual growth in oil demand stood at 1.2m barrels a day, although IEA data showed a slower y/y growth in 1Q19 and 2Q19, at 0.3m barrels a day and 0.8m barrels a day, respectively. While a seasonal pickup in demand is expected in 2H19, we believe it would be prudent to cut oil's annual demand growth projections further to 1.0m barrels a day y/y in FY19/20, factoring in slower growth from both China and the US as the trade war plays out. Globally, we are already seeing signs of decelerating manufacturing activities, slowing automobile sales in key markets like China and India, and falling air freight levels – signs cautioning weaker demand.

We now forecast oil prices to average around the USD65/bbl mark in 2H19/2020, with the base case scenario that there will be some form of trade war resolution in the coming months, down from our previous forecast of USD70-75/bbl. In the event there is no resolution following the next round of US-China trade negotiations in September, we would not be surprised if Brent tests the USD55/bbl level or even lower.

Table 1: DBS quarterly average oil price forecast

(USD per barrel)	1Q19A	2Q19A	3Q19E	4Q19F	1Q20F	2Q20F	3Q20F	4Q20F
Average Brent crude oil price	64.0	68.5	62.5	65.0	64.0	63.0	65.5	66.0
Average WTI crude oil price	55.0	60.0	56.5	59.0	58.0	57.0	59.5	60.0

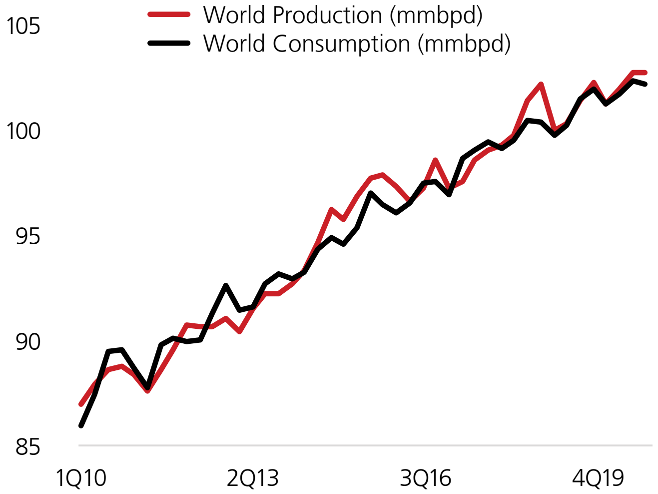
Source: DBS

Inventory drawdowns do not have a material impact on oil price

US crude inventory drawdowns fail to impact the oil markets. We expected sharp crude drawdowns in 2H19 – a result of OPEC's production cuts and sanctions placed against Iran and Venezuela – to support gradual upward price momentum. However, the drawdowns, totalling some 58m barrels over the last 11 weeks, have failed to enthuse the market beyond a day or two, as demand concerns continue to dominate investment flows. It is also important to note that US net oil imports have been falling as US oil exports pick up. This means to a certain extent, the US has been exporting its inventories to the rest of the world.

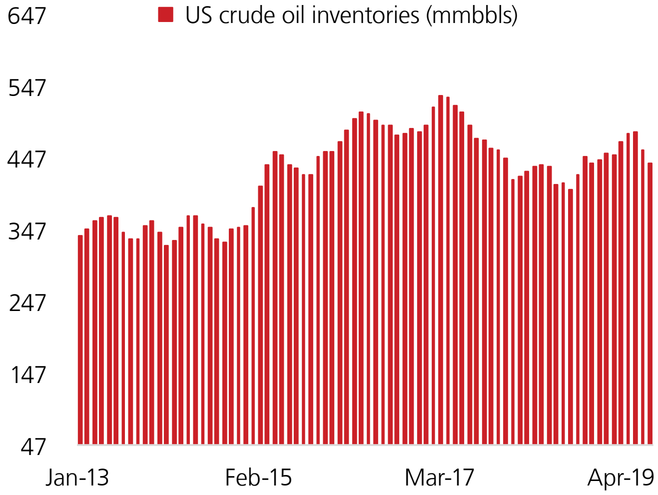
US production is starting to pick up in 2H19 and will limit any oil price increase. The pace of US shale oil production growth slowed down significantly in the early months of 2019. This came on the back of declining rig counts in the shale regions, due to muted capex growth and a multitude of technical problems affecting productivity growth. But as pipeline infrastructure improves in the Permian Basin and the number of completed wells increase, shale production is expected to grow again from 2H19 onward despite falling rig counts. This will continue to cap optimism.

Figure 15: Supply is expected to outpace demand in near-term, though not by much



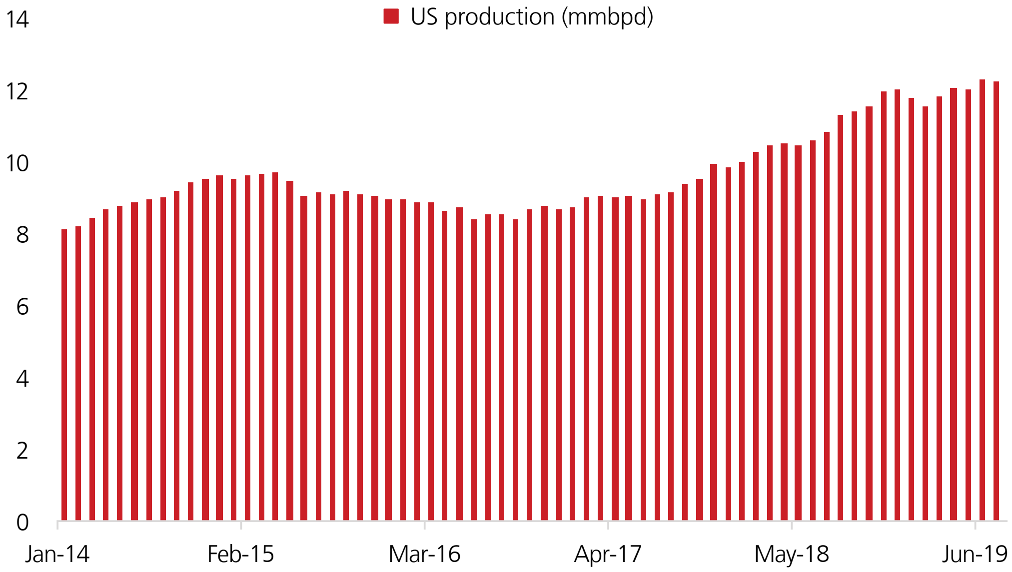
Source: US Energy Information Administration (EIA), DBS (forecasts)

Figure 16: Inventory declines are not enough to support oil price uptrend



Source: Bloomberg, DBS

Figure 17: US oil production flattened out in early months of 2019, but is picking up now



Source: Bloomberg, DBS

Potential supply shocks on escalating Middle East tensions remain a wild card

Escalating geopolitical tensions in the Middle East could lead to supply shocks and pose upside risk to oil prices. Geopolitics-led supply disruption is back in the limelight following massive drone attacks on Saudi's plants in mid-September that crippled half of its production, or c.5% of global oil supply. If Saudi production ramp-up is protracted and tensions in the Persian Gulf remain elevated, there could be upside risks to our c.USD65/bbl oil price forecast for the rest of 2019.

Table 2: GDP growth and CPI inflation forecasts

	GDP growth, % y/y				CPI inflation, % y/y, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
Mainland China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	0.0	0.5	1.5	2.5	2.7	2.5
India*	8.2	7.2	6.8	6.2	4.5	3.6	3.4	3.6
Indonesia	5.1	5.2	5.0	5.1	3.8	3.2	3.2	3.4
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	0.9	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	0.7	1.8	0.6	0.4	0.5	1.1
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	0.5	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.0	3.2	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	2.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.8	0.7	0.5	0.5	1.0	0.8	1.3
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

*Refers to year ending March. **New CPI series. ***End of period for CPI inflation. Source: CEIC, DBS

Table 3: Policy interest rates forecasts, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
Mainland China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.40	5.00	5.00	5.00	5.00	5.00
Indonesia	6.00	6.00	5.25	5.00	5.00	5.00	5.00	5.00
Malaysia	3.25	3.00	3.00	2.75	2.75	2.75	2.75	2.75
Philippines	4.75	4.50	4.25	4.00	4.00	4.00	4.00	4.00
Singapore**	1.95	1.95	1.80	1.60	1.60	1.60	1.60	1.60
South Korea	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.25
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.25
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.20	-0.20	-0.20	-0.20	-0.20
United States	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00

*1-yr lending rate. **3M SOR. ***Prime rate. Source: CEIC, DBS

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Glossary of Terms:

Acronym	Definition
ASEAN	Association of Southeast Asian Nations
AxJ	Asia ex-Japan
bbl	barrel
BI	Bank Indonesia
BNM	Bank Negara Malaysia
BOE	Bank of England
boepd	barrels of oil equivalent per day
BOJ	Bank of Japan
BOK	Bank of Korea
BOT	Bank of Thailand
bpd	barrels per day
BSP	Bangko Sentral ng Pilipinas
CAGR	compound annual growth rate
capex	capital expenditure
CAR	capital adequacy ratio
CET1	common equity tier 1
CPI	conusmer price index
DM	Developed Markets
DPS	dividend per share
DPM	discretionary portfolio mandates
DPU	distribution per unit
DXY	US Dollar Index
EBITDA	earnings before interest, tax, depreciation, and amortisation
EC	European Commission
ECB	European Central Bank
EIA	Energy Information Administration
EM	Emerging Markets
EPFR	Emerging Portfolio Fund Research
EPS	earnings per share
ETF	exchange-traded fund
EU	European Union
FCF	free cashflow
FDI	foreign direct investment
FTA	free trade agreement
FX	foreign exchange
GDP	gross domestic product
GFC	Global Financial Crisis
HY	high yield

Acronym	Definition
IEA	International Energy Agency
IG	investment-grade
IMF	International Monetary Fund
IP	intellectual property
ISM	Institute for Supply Management
IT	Information Technology
JGB	Japanese Government Bond
KTB	Korean Treasury Bonds
LTRO	long term refinancing operation
M&A	merger & acquisition
MAS	Monetary Authority of Singapore
mmbbl	million barrels
mmbpd	million barrels per day
MSG	Malaysia Government Securities
NAV	net asset value
NEER	nominal effective exchange rate
NII	net interest income
NIM	net interest margin
NPL	non-performing loan
O2O	online to offline
OMO	open market operations
OPEC	Organization of the Petroleum Exporting Countries
OPM	operating profit margin
P/B	price-to-book
P/E	price-to-earnings
P/NAV	price-to-net asset value
PBOC	People's Bank of China
PCE	personal consumption expenditure
PM	portfolio manager
PMI	purchasing managers' index
QE	quantitative easing
RBA	Reserve Bank of Australia
RBI	Reserve Bank of India
REIT	real estate investment trust
RM	relationship manager
ROA	return on asset
ROE	return on equity
RPGB	Philipine local government bonds

Acronym	Definition
RRR	reserve requirement ratio
SAA	Strategic Asset Allocation
saar	seasonally adjusted annual rate
SD	standard deviation
SGD NEER	Singapore dollar nominal effective exchange rate
SGS	Singapore Government Securities
SOE	state-owned enterprise
SOR	swap offer rate
TAA	Tactical Asset Allocation
UCITS	Undertakings for Collective Investment in Transferable Securities
UST	US Treasury
VaR	value at risk
VAT	value-added tax
VIX	CBOE Volatility Index
WTI	West Texas Intermediate
YTD	year-to-date
YTW	yield to worst
WTO	World Trade Organization
ZIRP	zero interest rate policy