Economics & Strategy Research

DBS Monthly

Hard Brexit and other disruptive scenarios

Group Research

25 January 2019

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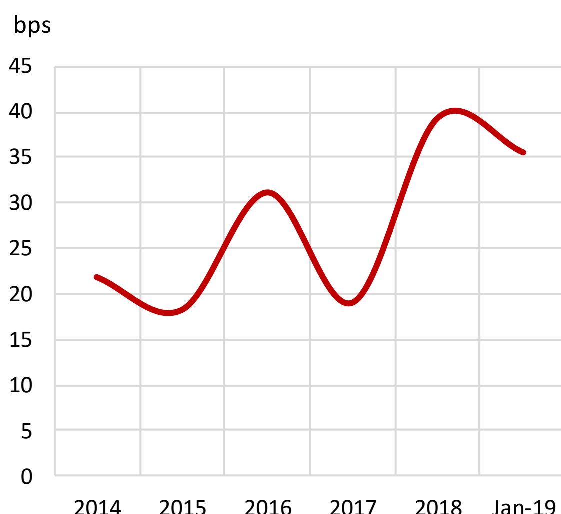
UK 5-year CDS

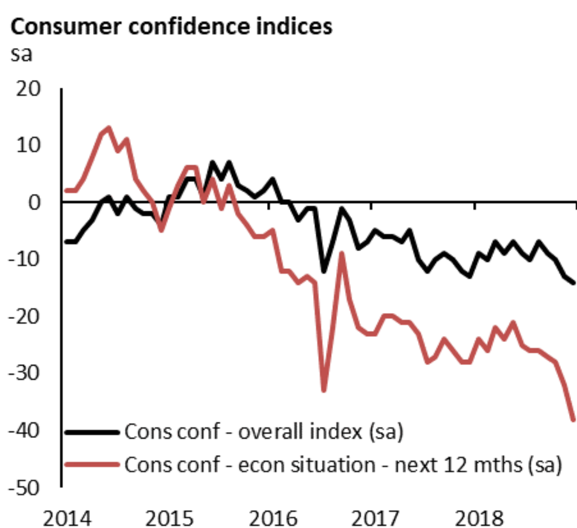


Source: Bloomberg, DBS Group Research. End-year data for 2014-18. Last data point is Jan 24, 2019

- ***Economics:*** *With deteriorating trade data, global growth slowdown has become a common refrain. Weakening sentiments make the outlook fragile, raising the susceptibility to shocks. A year ago, we would have bothered little about a hard Brexit scenario. Now, it matters, given the cyclical soft patch. Beyond the UK, event risks in Europe are rising as well.*
- ***FX****: A no-deal Brexit currency fallout would likely be worse than the Brexit referendum.*
- ***Rates:*** *If a hard Brexit takes place, UK Gilt yields would be sharply lower across all tenors. The silver lining is that the markets have probably semi-braced for hard Brexit. The UK's 5Y credit default swap (CDS) spreads have already widened close to 2016's peak as uncertainties mount*
- ***Equities****: While the UK's market is relatively modest for Singaporean firms, investors should still be defensive in this scenario and exercise caution over companies with both UK and Eurozone exposure.*
- ***Credit****: Asian credits, in general, have limited exposure to the UK and, hence, fundamental impact of a hard Brexit is not significant.*

Economics: Hard Brexit and other gathering risks on Europe's horizon

The UK has been the second largest economy in the European Union-28 (after Germany), so its pipeline departure has major ramifications in any case. But the un-ending uncertainty around the departure is particularly damaging. Moreover, the soon approaching end to the two-year deadline to depart under Article 50 comes at an inopportune time, as cyclical forces slow growth, while the political environment turns more challenging. Consumer sentiment gauges have been bearing the brunt of the compounding uncertainty.



Source: CEIC, GfK Group, DBS Group Research

The EU and the UK are inter-twined on the FDI and trade front. Half of the UK's goods trade is with the EU. By contrast, less than a fifth of EU28's trade (intra-EU) is with the UK. On investments, the UK was amongst the top few countries (besides Netherlands and Luxembourg) in the bloc, to attract the most FDI. In turn, the EU is the amongst the largest sources of UK inward FDI positions when using the immediate parent country, accounting for 45% of total inward positions, according to the Office of National Statistics. However, when linking to the ultimate controlling parent country, the EU and the North America recorded a similar quantum.

There is a key difference between the post-referendum period in mid-2016 and a potential no-deal outcome, at present. In the past two and a half years, there has been no material change in the UK's trading relationship with the EU. Yet there has been tangible, even if modest, impact on the UK economy, through slower growth (1.8% in 2016 to 1.4% in 1Q-3Q18), weaker net exports and inflation pullback, after the initial rise (due to a weaker GBP). The stronger growth backdrop in the Eurozone, US and globally, however, helped prevent a deeper economic correction in the UK.

This strength runs the risk of running out of steam if ongoing negotiations lead the UK down the road of a no-deal Brexit. Prime Minister Theresa May has opted to keep the 'no-deal' outcome as a possibility on the table, if discussions with the parliament breaks down before the end-March deadline. Such an outcome would imply that the advantageous Britain's access to Europe's single market (with low/zero tariffs and lower technical, legal and bureaucratic hurdles to trade/conduct business) will cease to exist. Imposition of trade barriers or increase in tariffs would hurt European and UK exporters. Given the geographical proximity and significant share of bilateral trade between the EU and UK, the push to seek emergency/bilateral commercial agreements will be high, but UK's higher reliance on trade with the EU suggest the terms might not be in its favour.

More importantly, UK growth slowdown risks are rising, at a time when activity in the broader EU (particularly Germany, France etc.) is also moderating. The political environment is also more challenging, as Eurosceptic and right-wing parties have increased their foothold in the core economies. The EU governments took a hard-line approach towards the UK in wake of the referendum. The tougher political climate in the past two years, however, will push them to seek a middle road – wary of setting a precedent for economies seeking to exit the EU but yield some ground to the UK to minimise any negative fallout on the EU growth/investments. In recent remarks, the Bank of England Governor had highlighted that the authorities have built in the risk of a 'hard Brexit' in their assessment. Back in November 2018, a BOE study had estimated that UK growth might decline by 8%, unemployment might rise to 9% and interest rates might need to be raised.

With businesses not adequately prepared for trade disruptions, and markets yet to discount risks of a no-deal Brexit, the risks are skewed to the downside at this juncture, in our view.

Taimur Baig and Radhika Rao

FX: No-deal Brexit currency fallout could be worse than the Brexit referendum

The British pound has rebounded to above 1.30 on hopes that the United Kingdom would avert a no-deal Brexit on 29 March. Expectations have increased for the UK to request an extension of the Brexit deadline, especially after the House of Commons rejected Prime Minister Theresa May's withdrawal agreement with the EU on 15 January and the failed no-confidence vote against her government the following day.

As far as Brexit is concerned, it is prudent to be guarded against false optimism. Before mulling new elections or a second referendum, there is no assurance that UK lawmakers can agree on requesting an extension, and Brussels acceding to one if they do. The major hurdle to an extension is the upcoming European Parliament elections on 23-26 May. On that account, **a disorderly Brexit on 29 March cannot be totally discounted.**

The Brexit referendum resulted in two rounds of trade-weighted depreciation in the British pound

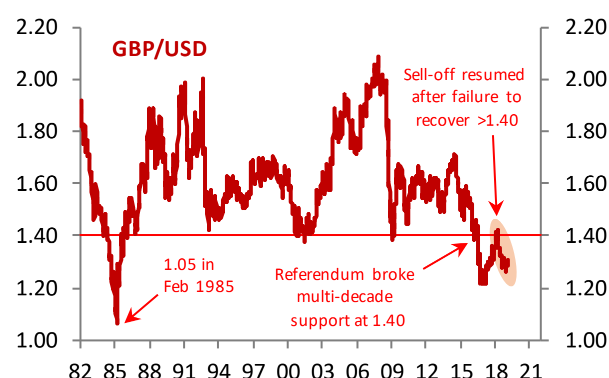
% change vs USD

	Round 1	Round 2	Total
From	23-Jun-16	6-Sep-16	23-Jun-16
To	7-Jul-16	11-Oct-16	11-Oct-16
GBP	**-13.2**	**-9.8**	**-18.5**
EUR	-2.8	-1.8	-2.9
CHF	-2.1	-1.9	-3.1
AUD	-1.8	-1.9	-1.0
JPY	5.3	-1.4	2.6
CNY	-1.5	-0.8	-2.1
PHP	-1.2	-4.3	-4.5
SGD	-0.9	-2.4	-3.0
TWD	-0.7	-0.7	1.3
KRW	-0.4	-1.4	2.7
THB	-0.3	-2.4	-0.9
INR	-0.2	-0.0	1.1
VND	0.0	-0.0	0.0
MYR	0.1	-2.3	-3.9
IDR	0.8	0.7	1.7

The main takeaway from Brexit was a post-referendum trade-weighted depreciation in the pound. Asian currencies were clearly more resilient than their European counterparts due to their limited trade exposure to the UK and geography. With financial markets caught off-guard by the shocking and unexpected "Yes" vote, there was a flight to safety into the Japanese yen during the first sell-off in the sterling in June-July 2016. The yen did not reprise its safe haven role during second sell-off in September-October because the Trump Rally had bolstered financial markets into and after the US presidential election in November. This coupled with a US dollar rally into a Fed hike in December resulted in a slower trade-weighted depreciation in the pound during the second round.

These post-referendum experiences suggested that if no-deal Brexit materializes on 29 March 2019, it would result in another trade-weighted depreciation in the pound. The negative spillover effects into the European and Asian currencies will probably be greater than those experienced during the referendum.

BOE's worst-case scenario for a disorderly Brexit sees GBP/USD falling to its 1985 low



Sources: DBS Research, Bloomberg data

According to the Bank of England, the worst-case scenario of **a disorderly Brexit** is a 25% devaluation that **would return the pound to its all-time low of 1.05 in 1985**. This will be deeper than the total 18.5% fall over 3-4 months seen immediately after the referendum in June 2016. This is not an unreasonable outcome.

If Brexit is not extended, Britain and the Eurozone are near the end and not at the start of Brexit negotiations, and ill prepared to cope with a no-deal Brexit. This **comes at the worst time when world economy has become cyclically vulnerable** to the slowdowns in the large economies (Eurozone, China and Japan), weakness in the tech sector, higher US interest rates and US-China trade tensions. The US dollar is also underpinned by America's relatively stronger growth/inflation/rate outlook against other Developed Market countries. Taking everything into consideration, **Emerging Asian economies will probably be less inclined to resist depreciation.**

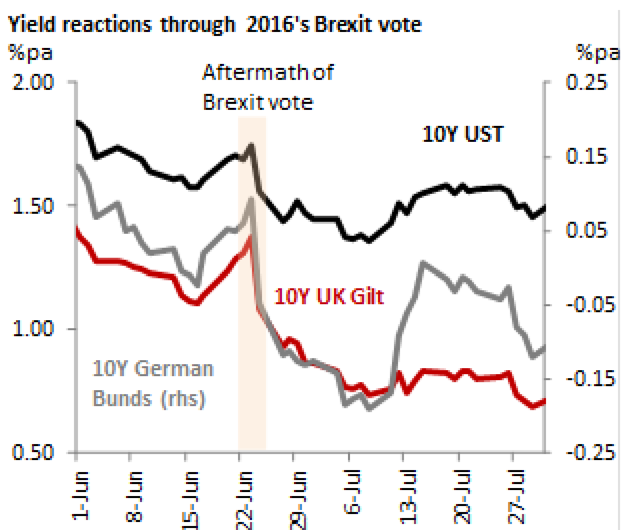
Philip Wee

Rates: Semi-braced for Brexit

If a hard Brexit takes place, UK Gilt yields would be sharply lower across all tenors. Conditions in 2016 appear broadly similar to what we are experiencing now. Back then, sentiment was battered from China worries (RMB devaluation) and the crash in oil prices. Now, sentiment is just as fragile as the global economy grapples with slowing growth. It might not take much to move DM yields sharply lower. The impact would be particularly acute in the 10Y tenor with declines in the 20bps range for UK Gilts. Taking the June 2016 Brexit vote experience, 10Y yields were down 30bps overnight and continued grinding lower over the coming weeks. Similarly, rate hike bets would be off the table and could conceivably turn to cuts. Notably, the Bank of England (BOE) cut rates by 25bps in the aftermath of the vote. We should expect significant spillover unto European and US govvies. Back then, 10Y US and German yields fell by 20bps and 15bps respectively over a one-day period implying a passthrough of 50-70%. Aside from an initial wobble, we would expect Asia govvies to also perform.

The silver lining is that the markets have probably semi-braced for hard Brexit. The UK's 5Y CDS spreads have already widened close to 2016's peak as uncertainties mount. Meanwhile, the 10Y yield spread between USTs and UK Gilts has also widened towards 140bps, from 60bps in mid-2016, reflecting the increased political risk premium that has been hampering the UK's growth prospects. Therefore, we think that **the adjustments needed across DM rates may be smaller compared to 2016 when the Brexit vote came as a shock.**

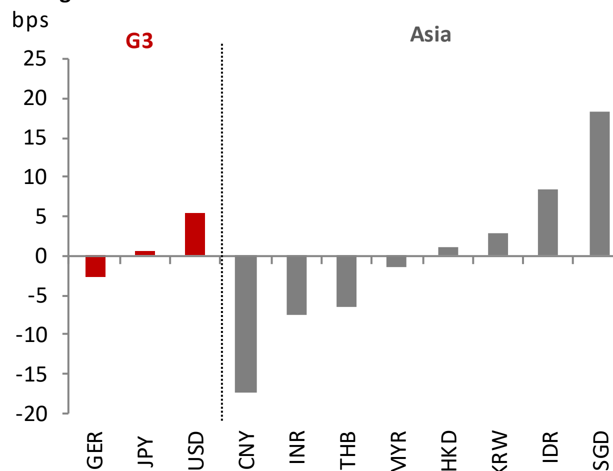
Yield reactions through 2016's Brexit vote



Stalemate

January proved to be volatile for the markets. The start of 2019 marked a continued deterioration in already weak sentiment in December. Coupled with thin liquidity, the selloff in risky assets was exacerbated driving 10Y UST yields briefly towards 2.55% (some 70bps off the high in November). The front of the curve was not spared with Fed funds futures factoring a rate cut by end-2019. This extreme pessimism faded by mid-January as a chorus of less-hawkish comments from the Fed (we see two hikes this year, down from four in 2018), news of Chinese stimuli and hopes of a China-US trade deal boosted risky assets. However, at current levels, we think that the markets will be rangebound, awaiting further catalysts either on the policy or economic front.

Change in 10Y Government Bond Yields since end-2018



Source: Bloomberg

The backdrop of slowing global growth, China-US trade talks and the US government shutdown will weigh on markets in the coming few weeks. China and Eurozone growth has been slowing with manufacturing PMI numbers grinding lower over the past few quarters. The US is the most resilient amongst the large economies. However, manufacturing weakness is also showing in US data. With these in mind, the People's Bank of China (PBoC) is already in easing mode, with RRR to be delivered in the coming months. Flushed liquidity will keep govvie yields depressed and this would eventually filter into IG credit spreads.

Meanwhile, the European Central Bank (ECB) has stopped quantitative easing but further normalisation is not imminent. Interestingly, lack of ECB support did not lead to higher German yields as growth concerns dominate. In any case, the ECB should be tilting towards

supporting the economy via extending or re-launching targeted long-term refinancing operation (TLTRO) to replace those that will be maturing. On balance, this should be viewed as a dovish tilt with rate hikes likely to be mooted only in 2020.

For Asia, rates are somewhat mixed. A less-hawkish Fed is undeniably positive for rates, providing room for central banks to hold rates. This month, Malaysia, Indonesia and South Korea kept rates unchanged. However, the prospect of a sharp rally is dim. Asia is still facing growth challenges and volatility likely to linger, it is difficult to see a return of investor enthusiasm on the same level as 2017. Even if volatility does settle, the focus would probably return to the Fed, bringing USD rates higher, putting pressure on Asia. The upshot is that the higher-yielding govvies (Indonesia, India and Philippines) present much better value at current levels. However, much of the total return would probably be from the coupon, rather than capital gains.

Running ideas:
-long 3Y Indo govvie (7th Jan 19)
-short Dec-2019 Fed funds futures (7th Jan 19)

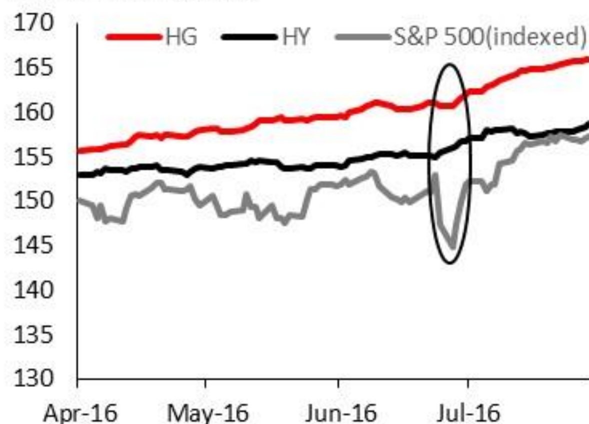
Eugene Leow

Credit: Limited fundamental impact

Asian credits, in general, have limited exposure to the UK and, hence, fundamental impact of a hard Brexit is not significant. For the few credits that have some exposure (e.g. Tata Motors, Tata Steel, Lodha and some other property developers, Hutchison group, etc), we believe the impact is manageable (e.g. diversified operations, UK assets being a small percentage of portfolio in the case of property, developers, etc). Besides, most credits currently are driven by other key considerations (e.g. capex in the case of Tata Motors) and we see the UK exposure as having a lower impact on bond performance. High grade credits (e.g. Hutch) should be even more insulated.

Hence, we would expect Asian credits to be resilient to Brexit developments as we saw in June 2016, following the surprise result from the referendum. However, if broader market sentiment weakens for a prolonged period, this should spill over to the credit markets. In 2016, the negative equity market reaction was short lived, which helped in supporting the credit market's muted reaction. Should there be a significant correction in bond prices following a potential hard Brexit, we would see that as an opportunity to buy the better-quality names.

Asian credit: muted reaction to Brexit referendum (2016)



Note: Bloomberg Barclays total return indices for Asian HG and HY; S&P 500 indexed to 150 as of 1 April 2016
Source: Bloomberg, DBS

Neel Gopalakrishnan

Equities: Hard Brexit will hurt risk appetite

To begin with, global growth outlook is already weakening. Sentiments will be further undermined under a hard Brexit scenario. One should expect a further slowdown in growth momentum amid heightened uncertainty.

Against uncertainty in the global backdrop, one can expect a dovish tone to be set by global central banks, especially the ECB. However, the street could continue to have a bias towards a strong USD, which in general is negative for Asia assets. The strong USD view resulting from the event could drive fund flows back to the US, thus supporting the various US asset classes including US equities. There is a risk that Asian currencies would weaken meaningfully in this scenario.

The direct fundamental impact on Asian equities should be minimal as exposure to the UK is limited to a few companies. In Singapore, there are companies which have investments in bus operations, hotels, and utility plants in the UK but contribution to earnings is insignificant unless we are referring to a drastic drop in the pound. In the case of the company with its UK bus operations, our analyst estimates that a 10% change in GBP vs SGD will have approximately 1.5% impact on the group profit.

The search for safe havens could also drive global bond yields significantly lower. Back in 2016, when UK voted to leave EU in the referendum, the US 10-year bond yields went as low as 1.36% and German bond yields into negative territory. The flat or inverse yields curve could depress the outlook for banks as interest margins come under pressure and a weak growth environment is already threatening the outlook for loans resulting in higher level of non-performing loans (NPLs). Banks, being index heavy weights in global benchmarks, should hinder the upward trajectory of global indices, if any. Although Asian banks have yet to suffer from a flat yield curve, relative valuations of Asian banks vs European banks make Asian banks look unattractive.

Investors should still be defensive in this scenario and avoid companies with UK and Eurozone exposure. Global search for yields in a low bond yields environment should still favour the Singapore REITs.

Joanne Goh

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Top-10 investment strategies for 2019

#1 Bet on more rate hikes by the Fed
#2 Looking for USDSGD to hit 1.40
#3 Long Indonesian equities
#4 Support for high grade credit, especially BBB
#5 Bullish 10Y China govvies
#6 Short AUD
#7 We like short-dated Chinese BBs for carry
#8 India govvies curve to steepen
#9 Short CNY
#10 Long S-REITS as a defensive play

Growth, Inflation, Policy Rates & FX forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018f	2019f	2020f	2017	2018f	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	7.1	6.7	7.1	7.4	4.5	3.6	4.0	4.2
Indonesia	5.1	5.1	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.1	2.5	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.3	4.7	3.8
Singapore	3.6	3.4	3.0	2.8	0.6	0.7	1.8	1.5
South Korea	3.1	2.7	2.6	2.4	1.9	1.5	1.7	1.6
Taiwan	3.1	2.7	2.2	1.8	0.6	1.4	1.0	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.4	1.5
Vietnam	6.8	6.9	6.6	6.3	3.5	3.6	3.8	3.4
Eurozone	2.5	1.9	1.8	1.8	1.5	1.8	1.4	1.4
Japan	1.9	1.0	1.0	0.5	0.5	1.0	1.1	1.6
United States***	2.3	3.0	2.5	1.5	2.1	2.6	2.5	2.5

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.00	3.00
Philippines	4.75	4.75	4.75	4.75	4.75	4.75	4.75	4.75
Singapore**	1.80	2.05	2.30	2.30	2.30	2.30	2.30	2.30
South Korea	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
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	0.25	0.25	0.50	0.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00
United States	2.50	2.75	3.00	3.00	3.00	3.00	3.00	3.00

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
China	7.10	7.20	7.15	7.10	7.05	7.00	6.95	6.90
Hong Kong	7.85	7.85	7.84	7.83	7.82	7.81	7.80	7.79
India	74.0	75.0	76.0	77.0	76.5	76.0	75.5	75.0
Indonesia	15000	15200	15400	15600	15500	15400	15300	15200
Malaysia	4.25	4.30	4.28	4.25	4.23	4.20	4.18	4.15
Philippines	53.5	54.0	54.5	55.0	54.8	54.5	54.3	54.0
Singapore	1.42	1.44	1.43	1.42	1.41	1.40	1.39	1.38
South Korea	1180	1200	1190	1180	1170	1160	1150	1140
Thailand	33.5	34.0	33.8	33.5	33.3	33.0	32.8	32.5
Vietnam	23500	23600	23550	23500	23470	23440	23410	23380
Australia	0.68	0.66	0.67	0.68	0.69	0.70	0.71	0.72
Eurozone	1.10	1.08	1.09	1.10	1.11	1.12	1.13	1.14
Japan	116	118	117	116	115	114	113	112
United Kingdom	1.26	1.24	1.23	1.22	1.23	1.24	1.25	1.26

Australia, Eurozone and United Kingdom are direct quotes

Rates forecasts

		2019 Q1	Q2	Q3	**Q4**	2020 Q1	Q2	Q3	**Q4**
US	3m Libor	2.70	2.95	3.20	**3.20**	3.20	3.20	3.20	**3.20**
	2Y	2.70	2.85	3.00	**3.00**	3.00	3.00	3.00	**2.90**
	10Y	2.80	2.90	3.00	**3.00**	3.00	3.00	3.00	**2.90**
	10Y-2Y	10	5	0	**0**	0	0	0	**0**
Japan	3m Tibor	0.05	0.05	0.05	**0.05**	0.05	0.05	0.10	**0.10**
	2Y	-0.08	-0.05	-0.03	**0.00**	0.02	0.04	0.05	**0.05**
	10Y	0.14	0.16	0.18	**0.20**	0.20	0.20	0.22	**0.22**
	10Y-2Y	22	21	21	**20**	18	16	17	**17**
Eurozone	3m Euribor	-0.30	-0.30	-0.30	**-0.30**	-0.05	0.20	0.20	**0.20**
	2Y	-0.55	-0.40	-0.25	**-0.10**	0.05	0.15	0.15	**0.15**
	10Y	0.20	0.30	0.40	**0.50**	0.50	0.50	0.50	**0.45**
	10Y-2Y	75	70	65	**60**	45	35	35	**30**
Indonesia	3m Jibor	7.50	7.50	7.50	**7.50**	7.50	7.50	7.50	**7.50**
	2Y	7.50	7.50	7.50	**7.50**	7.50	7.50	7.50	**7.50**
	10Y	8.10	8.20	8.20	**8.20**	8.20	8.20	8.20	**8.00**
	10Y-2Y	60	70	70	**70**	70	70	70	**50**
Malaysia	3m Klibor	3.65	3.65	3.65	**3.65**	3.65	3.65	3.40	**3.40**
	3Y	3.75	3.75	3.75	**3.75**	3.75	3.75	3.60	**3.60**
	10Y	4.15	4.20	4.25	**4.30**	4.35	4.35	4.30	**4.25**
	10Y-3Y	40	45	50	**55**	60	60	70	**65**
Philippines	3m PHP ref rate	5.55	5.55	5.55	**5.55**	5.55	5.55	5.55	**5.55**
	2Y	6.75	6.75	6.75	**6.75**	6.75	6.75	6.75	**6.75**
	10Y	7.00	7.00	7.00	**7.00**	7.00	7.00	7.00	**6.90**
	10Y-2Y	25	25	25	**25**	25	25	25	**15**
Singapore	3m Sibor	1.80	2.05	2.30	**2.30**	2.30	2.30	2.30	**2.30**
	2Y	1.90	2.05	2.20	**2.20**	2.20	2.20	2.20	**2.10**
	10Y	2.15	2.25	2.35	**2.35**	2.35	2.35	2.35	**2.25**
	10Y-2Y	25	20	15	**15**	15	15	15	**15**
Thailand	3m Bibor	1.85	1.85	1.85	**1.85**	1.85	1.85	1.85	**1.85**
	2Y	1.80	1.80	1.80	**1.80**	1.80	1.80	1.80	**1.80**
	10Y	2.40	2.40	2.50	**2.60**	2.60	2.60	2.60	**2.50**
	10Y-2Y	60	60	70	**80**	80	80	80	**70**
China	1 yr Lending rate	4.35	4.35	4.35	**4.35**	4.35	4.35	4.35	**4.35**
	3Y	2.90	2.80	2.80	**2.80**	2.80	2.80	2.80	**2.80**
	10Y	3.20	3.15	3.10	**3.15**	3.20	3.25	3.25	**3.25**
	10Y-3Y	30	35	30	**35**	40	45	45	**45**
Hong Kong	3m Hibor	2.40	2.65	2.70	**2.70**	2.70	2.70	2.70	**2.70**
	2Y	2.10	2.30	2.40	**2.40**	2.40	2.40	2.40	**2.30**
	10Y	2.25	2.35	2.45	**2.45**	2.45	2.45	2.45	**2.35**
	10Y-2Y	15	5	5	**5**	5	5	5	**5**
Korea	3m CD	0.66	0.66	0.66	**0.66**	0.66	0.66	0.66	**0.66**
	3Y	0.60	0.60	0.60	**0.60**	0.60	0.60	0.60	**0.60**
	10Y	0.95	1.00	1.00	**1.00**	1.00	1.00	0.95	**0.90**
	10Y-3Y	35	40	40	**40**	40	40	35	**30**
India	3m Mibor	1.90	1.90	1.90	**1.90**	1.90	1.90	1.90	**1.90**
	2Y	2.10	2.15	2.20	**2.20**	2.20	2.20	2.15	**2.10**
	10Y	2.30	2.40	2.50	**2.50**	2.50	2.50	2.40	**2.30**
	10Y-2Y	20	25	30	**30**	30	30	25	**20**

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)

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