Weekly: Playing with fire

Economics/Strategy/Rates/FX/Equities

DBS Group Research

January 10, 2020

Taimur Baig
Chief Economist
taimurbaig@dbs.com

Duncan Tan
Strategist
duncantan@dbs.com

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

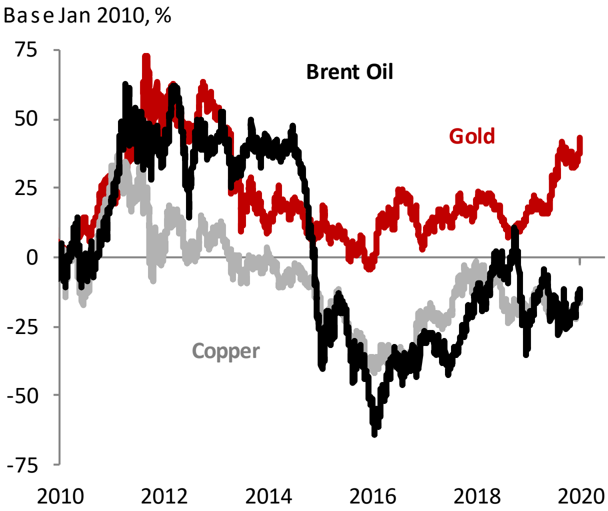
- *Bushfires in Australia and a US-targeted assassination of an Iranian general—2020 has begun with plenty of heat.*
- *Oil and gold prices have turned volatile, rates have rallied, but overall macro risks have not risen appreciably through the course of the week.*
- *Unless hostilities worsen considerably, the end-19 narrative of a modest trough in global manufacturing remains in place.*
- *But true to our 2020 Outlook title, a plethora of factors beyond economics will dominate the market narrative this year.*

Non-economic factors driving markets

The massive bushfires in Australia, partly driven by unusually dry conditions caused by climate change, has brought to the fore the costs of dealing with the ongoing climate crisis. As elucidated by our 2020 outlook's title, "Beyond Economics," developments like these are likely to increasingly drive market forces.

Last week's US orchestrated assassination of an Iranian general and subsequent market gyrations also illustrate the power of election considerations and geopolitical rivalry to influence the market narrative.

Brent Oil vs Copper vs Gold

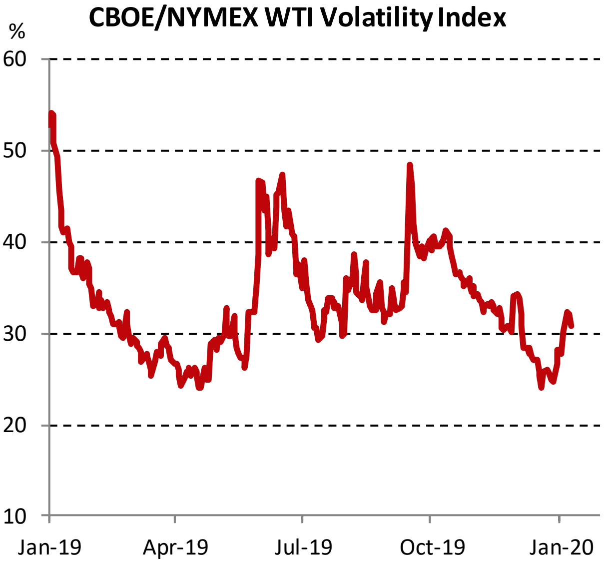


Source: Bloomberg

These developments have generated plenty of heat in the news, but market risk perceptions rose only modestly. For instance, the spike in oil around the event has been modest.

It is too early to look past the tensions in the middle-east, but we would not want to ignore other key pipeline developments.

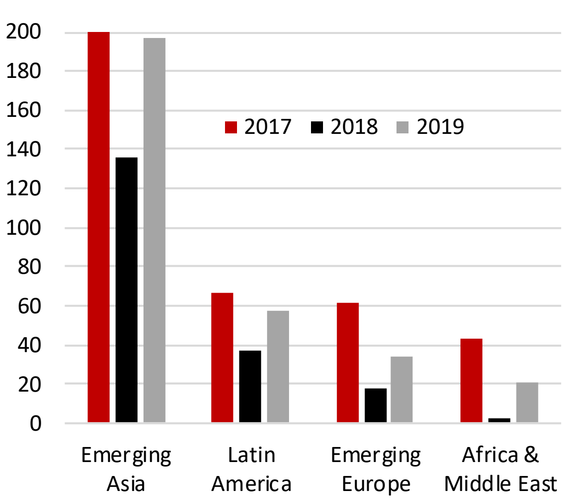
CBOE/NYMEX WTI Volatility Index



Source: Bloomberg, DBS

Global dataflow. We continue to expect a trough in glboal electronics and auto cycles, potentially boosting Asian exporters. Recent global PMIs already support the emergence of this outcome.

Net portfolio flows



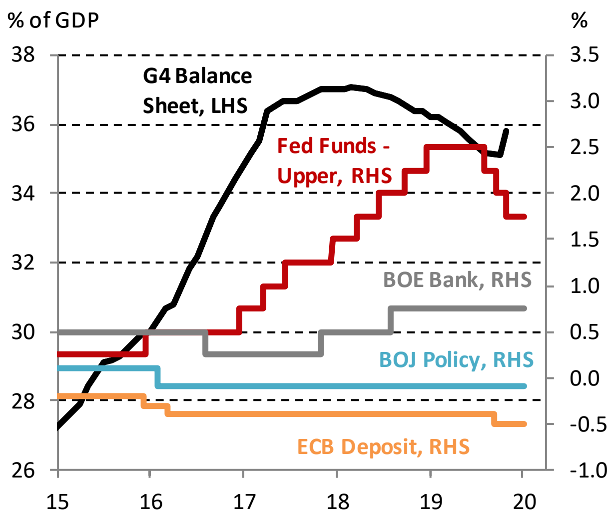
Source: IIF, DBS

Additionally, the US seems to be past the soft patch encountered in the early part of Q4; a few more good data points will hasten the rise in long-term yields. Low interest rates, strong asset market gains, record high employment, and sustained wage gains could create room for upside economic surprise.

Capital flow to Asia. Led by China, India, Indonesia, and South Korea (and Taiwan in recent months) Asian economies are seeing a turnaround in capital inflows. We see this as supporting our hypothesis that 2020 will be characterised by flows from expensive developed markets to EM Asia.

Global liquidity. A trend that began midway last year has taken a major lower-for-longer dimension. Policy normalisation is being discounted by the markets almost entirely for the time being. The risk however is that strong US data, combined with progress on the trade front with China, ignites the reflation trade, pushing up long term rates and tightening dollar funding conditions worldwide.

G4 Balance Sheet vs Policy Rates



Source: Bloomberg

US elections. Like him or not, Donald Trump has been good for US markets. As Democratic primaries begin, any rise in the probability of election of candidates like Elizabeth Warren and Bernie Sanders, who are pushing forward a tough stance on regulation and taxation, pose challenges to the market's present exuberance.

Taimur Baig

FX: A delicate recovery outlook peppered with market gyrations

Exchange rates have been broadly range-bound at the start of 2020, caught between heightened US-Iran tensions and a China-US trade truce. Without a disruption to oil supplies or overtures towards a full-blown war, the Mideast crisis did not crush investors' hope for a global recovery. Even so, markets will continue to gyrate with the likelihood for more tit-for-tat retaliation between the US and Iran. China is also expected to become a punching bag ahead of the US presidential election on November 3.

The Chinese yuan's appreciation for the Phase 1 trade deal may be limited to around 6.90. This level commensurate with the partial tariff rollback for the signing of the mini deal scheduled for January 15. US has halved the 15% tariff imposed on USD120bn of Chinese goods last September to 7.5% and scrapped the 15% tariff on USD160bn due December 15. The 25% tariff on USD250bn in place since May will stay. Doubts remain over China's ability to scale up purchases of US goods stipulated in the Phase 1 agreement. Moving towards and achieving a Phase 2 deal will be harder because of China's government subsidies to its state-owned companies.

A reality check is also in store for the British pound. The Tory majority at the UK elections on December 12 will assure UK's exit from the EU on January 31. The strong mandate is, however, not enough to overcome the shortened window and redlines to establish UK's future relations with the EU (not without trade-offs from No. 10) after the Brexit transition period that ends on December 31. In particular, businesses will want more clarity on the new trade relationship with the single bloc before committing to new investments and hiring. Against lackluster growth, low inflation and a weaker jobs market, the Bank of England has started to warm towards the rate cut pushed by its two MPC members. Expect the Budget announcement on March 11 to break the fiscal rules and increase spending to fulfill election promises. Having unwound their "no-deal Brexit" bets, speculators may find themselves reinstating their short GBP positions again and bring sterling into a lower 1.25-1.30 range.

The Australian dollar has depreciated back into its 0.67-0.69 range with a dovish bias. To help contain the economic fallout from one of the country's worst bushfires, the Reserve Bank of Australia is expected to deliver, its next meeting on February 4, its fourth rate cut in eight months. Prioritising bushfire help could lead the Morrison coalition to miss its campaign promise to deliver a budget surplus. The budget target was lowered only last month along with a weaker growth/inflation/jobs market outlook.

The Thai baht's appreciation may have hit a wall around 30. Business sentiment has plunged sufficiently for policymakers to consider the THB's strength as misplaced, out of line with weaker domestic fundamentals and regional currency weakness. The Bank of Thailand has allowed exporters to keep USD1mn of their proceeds abroad, a fivefold increase from the current USD200k limit. It will allow local companies and residents to keep foreign currency in the country and ease regulations for insurance companies to invest overseas.

Philip Wee

Rates: Navigating US-Iran tensions

US Treasury yields were pulled sharply lower over the past few trading sessions as US-Iran tensions grew. 10Y yields are now at 1.72%, down some 20bps since end-2019. **Short-term USD rates have also factored in an increasing chance of Fed cuts towards the second half of the year.** Meanwhile, inflation expectations have been steady with the 10Y breakeven rate at 1.74% (close to the average of 1.80% registered over the past five years.

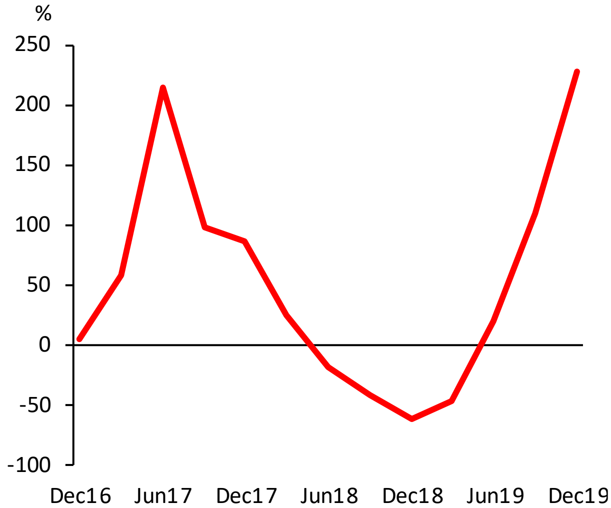
At this point, it is unlikely that military conflict between the two sides would be sufficient to nudge the Fed into easing further. However, from a positioning point of view, shorter duration US Treasuries appear safer than longer-term ones given our medium-term concerns on the US budget.

We are neutral on the curve at the moment. The risk-off mood has bull-flattened the 2Y/10Y segment of the curve by 10bps since the start of the year. We think it would be more interesting to put on steepeners if the spread tightens towards 15bps. **With geopolitical risks set to linger, tactical opportunities for outright pay positions in US swaps are appearing.**

Eugene Leow

Credit: Indian offshore issuance jumps

India: Offshore coporate issuance (4q/4q)

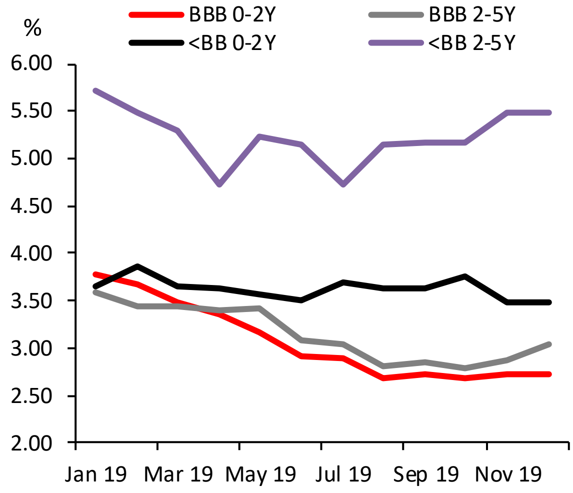


Source: Bloomberg, DBS

Beyond volatility spawning from the rise and fall of Middle East tensions, Asian credit markets have largely displayed a good appetite for a steady stream of issuance.

This is particularly evident in the Indian credit market, with offshore corporate issuance rebounding sharply in 2019. Indian companies, facing tight domestic financing conditions due to woes in the NBFC sector, are now turning more and more to the offshore market.

India: Offshore USD credits' average yield



Source: Bloomberg, DBS

Indian investment-grade (BBB) credit has seen yields coming off in line with lower UST yields. That said, the BB and non-rated credits have not seen that much of a fall in yield, given concerns of credit stresses following a defaullt by an Indian wind turbine maket. We see high-yield credit risk premiums to be quite attractive, with overall risk looking manageable.

Chang Wei Liang

Highlights of the week:

Currency fair values: What's cheap and what's DEER?

Chart of the Week: Asia PMIs trough

India: Banking on conducive global catalysts

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2018	2019f	2020f	2021f	2018	2019f	2020f	2021f
China	6.6	6.1	5.8	5.6	2.1	2.6	2.3	2.5
Hong Kong	3.0	-1.7	1.5	1.5	2.4	2.7	2.5	2.5
India	7.4	5.0	5.8	6.4	4.0	3.5	4.2	4.5
*India (FY basis)**	*7.1*	*6.8*	*5.0*	*5.8*	*3.6*	*3.4*	*3.9*	*4.2*
Indonesia	5.2	5.0	5.0	5.1	3.2	3.1	3.4	3.2
Malaysia	4.7	4.5	4.6	4.6	1.0	0.9	1.6	1.8
Philippines**	6.2	5.9	6.3	6.3	5.2	2.8	3.5	3.3
Singapore	3.1	0.7	1.4	1.8	0.4	0.6	1.1	1.5
South Korea	2.7	2.1	2.4	2.3	1.5	0.5	1.5	1.3
Taiwan	2.7	2.3	2.0	2.2	1.3	0.6	1.0	1.1
Thailand	4.1	2.5	3.0	3.2	1.1	0.8	1.2	1.3
Vietnam	7.1	7.0	6.8	6.7	3.5	2.8	2.9	3.0
Eurozone	1.9	1.2	1.3	1.5	1.8	1.2	1.2	1.3
Japan	0.8	0.7	0.5	0.9	1.0	0.5	0.7	0.6
United States***	2.9	2.2	1.9	1.8	2.0	1.7	1.7	2.0

* refers to year ending March i.e. 2020 represents FY20 - year ending March 2020 ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	5.15	5.15	5.15	5.15	5.15	5.15	5.15	5.15
Indonesia	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Malaysia	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Singapore**	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
South Korea	1.25	1.25	1.25	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	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Vietnam***	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
United States	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75

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

Exchange rates, eop

	Q1 20	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21
USD/CNY	7.20	7.15	7.10	7.05	7.00	6.95	6.90	6.85
USD/HKD	7.85	7.84	7.84	7.83	7.82	7.81	7.80	7.80
USD/INR	72.0	72.5	73.5	74.0	73.5	73.0	72.5	72.0
USD/IDR	14200	14300	14400	14500	14450	14400	14350	14300
USD/MYR	4.20	4.18	4.16	4.14	4.13	4.12	4.11	4.10
USD/PHP	52.0	51.5	51.0	50.5	50.4	50.3	50.2	50.1
USD/SGD	1.40	1.39	1.38	1.37	1.36	1.36	1.35	1.35
USD/KRW	1180	1175	1170	1165	1160	1155	1150	1145
USD/THB	31.0	30.8	30.6	30.4	30.3	30.2	30.1	30.0
USD/VND	23300	23300	23300	23300	23300	23300	23300	23300
AUD/USD	0.64	0.65	0.66	0.67	0.68	0.69	0.70	0.71
EUR/USD	1.08	1.09	1.10	1.11	1.12	1.13	1.14	1.15
USD/JPY	110	109	107	106	105	105	104	104
GBP/USD	1.20	1.21	1.22	1.23	1.24	1.25	1.26	1.27

Australia, Eurozone and United Kingdom are direct quotes

Group Research

Economics & Macro Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Ma Tieying, CFA
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Radhika Rao
Economist – Eurozone, India, & Thailand
+65 6878-5282 radhikarao@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

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