Three factors that could spoil a "Powell Put"

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- *Financial markets have gotten what they wanted—considerably dovish rhetoric from the Fed on both rates and balance sheet.*
- *This paves the way for continued equity market rally, further flattening of curves, and strong support for emerging markets.*
- *Enjoy the rally, but keep an eye on three major factors:*
- *First, US inflation expectations remain low, but could turn around in the second quarter as oil bottoms, wage growth continues, and capacity constraints appear.*
- *Second, a dovish Fed won't change China's fortunes. Increasingly, earnings of large companies rely on Chinese demand, hence its sustained slowdown would remain a major overhang in the near term.*
- *Notwithstanding a dovish Fed, the sustained widening of US fiscal deficit and debt will continue. Having rallied to sub-2.7%, the 10-yr yield outlook is asymmetric, in our view.*

Fed relent to sustain the ongoing market rally, but only for a few months

Flagging a host of "cross-currents", US FOMC Chairman Jerome Powell delivered to the markets a great deal of cheer this week. Given that the market had already priced-In a dovish tilt by the Fed, it required particularly neutral language to top expectations, but Mr. Powell pulled that off. Not only did he take rate hikes off the table for the time being, he addressed the other concern raised by the buyside community through the course of 2018—the pace of balance sheet adjustment. While pointing out that the Fed will be flexible and data dependent, the US central bank has moved away from its "auto-pilot" of gradual policy normalisation.

The risk with becoming data dependent and moving away from forward guidance is that the policy outlook (or at least the market's perception of it) may become more volatile. It will take just a handful of data points underscoring renewed strength in housing and auto sales and a few positive earnings releases to a return of fears that rate hikes are back on the table, in our view. The overwhelming wager however is that that is unlikely, as seen in the yield curves.

But let's be clear—the Fed did not reverse policy this week. By the end of the second quarter, if growth remains comfortably in the mid-2%, the labour market remains strong, and China slowdown does not become disorderly, there will be little hesitation to hike, in our view. Hence the move from sharp flattening to steepening could well be on the cards in a matter of months. At the other end of possibilities, a few more months of weak data may warrant yet another asset market tantrum and strident calls for a reversal of quantitative tightening. Either way, we think that the Fed has bought no more than a few months of financial market stability.

Under current conditions, it would be reasonable to expect for continued equity market rally, further flattening of curves, and strong support for emerging markets. The USD has corrected lately (although the DXY is still up more than 5%yoy), and can be expected to

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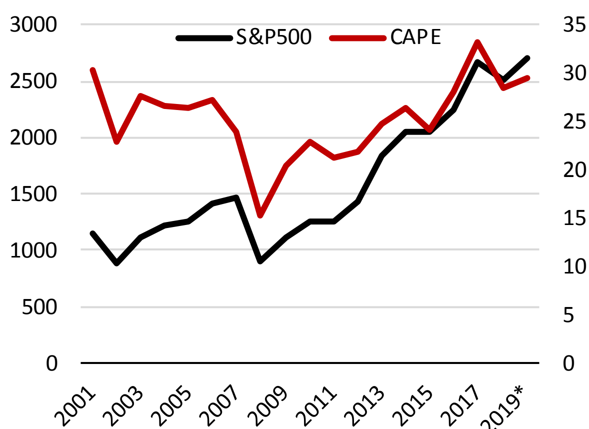
remain flat or a tad weaker. But our conviction is low with respect to the durability of this narrative.

Note a few complicating factors for the period ahead:

First, US markets are by no means cheap. The Case-Shiller cyclically-adjusted price-earning (CAPE) ratio for the S&P500 is close to the highest point seen in recent memory, and the ratio may well rise further given the mixture of softening earnings growth and rebounding stock prices. This points to limited upside for the market, which in turn means repeated demands for the "Powell Put" going forward. Particularly relevant in this context is the fact that a dovish Fed won't change China's fortunes. Increasingly, earnings of large companies rely on Chinese demand, hence its sustained slowdown would remain a major overhang in the near term.

Valuations are high by historical standards



End-year data. Jan 30 for 2019
Source: Bloomberg, and
http://www.econ.yale.edu/~shiller/data.htm

Second, contrary to the complaints about quantitative tightening creating a credit crunch, interest rates are exceptionally low, with real long term rate (derived from the difference between 10-year bond yields and average annual inflation) hovering at around 0.5%. This is not consistent with an economy growing at well above its rate of potential GDP growth. Unless growth or inflation rates slow sharply, nominal and real rates would have to rise this year. Given that US government deficit and debt are rising, with no consolidation effort likely to come from a highly antagonistic Congress and White House, Treasury issuance will continue to balloon. This can readily cause a reversal of the flattening trend.

Third, the utter lack of concern about inflation (as seen in the pricing of 5-year breakeven points) could come back to haunt the market even if growth does not jump sharply. The US labour market is tight and wages are rising, the price of oil may well have bottomed, and a China stimulus could buoy a broader range commodity prices. Short of a deterioration in the job markets, the scenario around inflation seems asymmetric to us. i.e. the chance of a downside surprise is smaller than an upward surprise. The market is not at all considering that.

With this background, we will keep our eyes on three matters that could spoil the "Powell Put": (i) scenarios under which inflation could surprise; (ii) dataflow out of China; and (iii) the ultra-flat yield curve.

Of course, the Fed will look prescient if China slowdown becomes deeper, Europe loses momentum further, geopolitical risks spike, and US consumer confidence wanes, taking the auto and housing markets with them. But the central bank may well rue such foresight, as that would be accompanied by calls for reversal of quantitative tightening and rate cuts, which it is not quite considering for this year. In its attempt to soothe asset market sentiments, the Fed may have over-corrected and brought into play dynamics that it is not keen to contemplate, in our view.

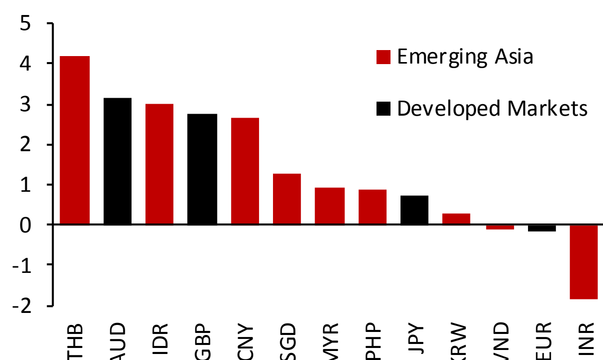
Taimur Baig

Strategy

FX: January's relief rally will be limited

Hope was the theme in January. 1) Hope for a less hawkish Fed. The Fed affirmed its patient stance at this week's FOMC meeting. 2) Hope for an easing of US-China trade tensions. China has agreed to buy more soya beans from America during the second round of trade talks. 3) Hope that the UK would avoid a no-deal Brexit on 29 March. Debate has intensified if the UK will extend Article 50, seek a second referendum and/or snap elections.

A relief rally for currencies in January 2019



Sources: DBS Research, Bloomberg data

Reality has not changed – the downside risks from 2018 have not gone away. China needs more fiscal/monetary policy measures to cushion the slowdown in its economy. Beijing is set to announce in March a lower 6-6.5% growth outlook for 2019. The Chinese yuan has probably discounted the optimism surrounding trade talks. The yuan has appreciated to its strongest level since July 2018 when the first round of US tariffs came into force. US President Trump is open to delaying more tariff hikes with no mention of reducing existing tariffs.

In the developed markets, the flat-to-weak euro best reflected the longer/deeper-than-expected Eurozone slowdown. With the US 10Y bond yield below 2.75%, where the Fed Funds Rate will be after its next hike, the resilience the USD is understandable. Finally, there is a need to guard against false optimism in the British pound. The odds remain for the UK to exit the EU on 29 March with or without a deal. **Hence, stay vigilant for the relief rally to peter out, especially as March nears.**

Philip Wee

Rates: Enjoy the risk on

This week marked another rally across stocks and govvies as the Fed emphasized patience and flexibility. While some of the dovishness was already reflected in the leadup to the Fed meeting, Powell delivered more than what the market expected by addressing quantitative tightening in a separate statement (no more autopilot). 10Y UST yields are down some 10bps (2.65%) from last week while the S&P 500 extended the rally for the year (up 7.9% ytd). The high-level China-US trade talks did not result in any negative headlines. Expectations for a sweeping deal were low to begin with and the market is probably relieved that trade tensions are no longer escalating. **That said, the 1st March deadline (where the US would slap even more tariffs on Chinese imports) looms.** If a deal is not struck by then, there would be a dent on sentiment.

We are comfortable with the two running ideas – short Dec-2019 Fed funds futures and long 3Y Indo govvie - put forth since 7th January. While the Fed has indicated that it is on pause for several months, it is premature to extrapolate this out through the whole year. If data holds up and market volatility subsides, speculation of rate hikes would return, driving USD rates higher. We think the market (pricing in flat for 2019 and a cut in 2020) may be a tad too dovish. This trade would be close to breakeven if the Fed stays on hold through 2019.

Meanwhile, we are willing to ride the rally in 3Y Indo govvie further. As conditions turn favourable for emerging market assets, Indo govvies, which offer high real and absolute yields, should be particularly attractive. Rate cuts may not be in the works but an improvement in liquidity conditions as inflows return should benefit the front of the Indo govvie curve.

Running ideas:

-long 3Y Indo govvie (7th Jan)

-short end-2019 Fed funds futures (7th Jan)

Eugene Leow

Asia Equities: January rally's sustainability contingent on Trade talks and USD

Asia equities surged in January amid a less hawkish Fed, lower oil prices, lower bond yields and weaker USD. The yield of the 10-year Treasury note slid to its lowest level in more than a year in early January following a change in the Fed's policy stance, thus driving a return of risk appetite for emerging market assets.

The case for Asia to perform in 2019 is strong. After a brutal year in 2018, valuations have slipped to near low levels amid heavy foreign outflows. Cash levels in December held by Asia ex-Japan fund managers continue to stay high since 2011, reflecting excessive prevailing pessimism. As some of the external headwinds eased into 2019, we believe there is upside risk for the region.

Near term however, we think Asia markets could take a breather as the markets continue to climb a wall of worries. Key events to watch out for market volatility to surge in the first half of 2019 are summarised in the following table. The outlook for Asia markets should be clearer once these critical events blow over.

Importantly, we believe there are downside risks to the current earnings season which will see more heavy- duty reports starting from mid-February. Banks is a key sector to watch out for in Singapore for downside risk. The progress made the US-China trade negotiation will have profound implications if the RMB depreciates further and if a deep global economic downturn can be avoided.

Else, we think lower oil prices and bond yields, coupled with a less hawkish Fed, should provide tailwinds to Indonesia and Philippines to outperform. Cheaper markets such as China / Hong Kong and Singapore could see re-rating should the trade deal turns out to be more positive than market expectations. We are overweight in these markets.

Key macro events to watch out for in 1H19

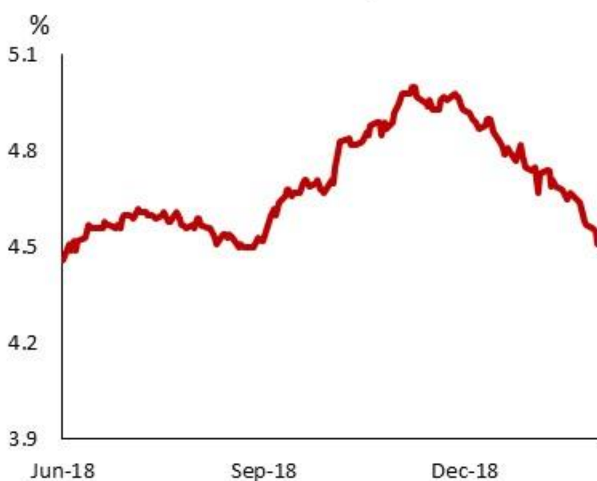
Month	Event	Impact
Jan	Markets have been adjusting growth outlook amid weak macro numbers, US government shutdown; on-going re-pricing of cyclical growth downturn and less hawkish US rate hike expectations	
Jan - Feb	Earnings season	Downgrades in earnings growth and outlook to intensify
Feb	End of US-China trade talks	Uncertainty prevails on whether the pain of a 25% tariff on both sides can be averted
Mar	US debt ceiling needs to be raised	Potential government default The US's unsustainable spending Bouts of market anxiety on dollar and EM
	FOMC meeting	Concerns over pace of tightening. Implications for change of policy stance and if the Fed does pause
	Brexit deadline	High volatility expected
	Thai elections	Political uncertainty is high
April	Indonesia presidential elections	One round; no new candidate hence unlikely to surprise
	FOMC meeting	Minutes to watch for change in stance
May	EU Parliament elections	Uncertainty on euro if event leads to a referendum on EZ
	Thai King's coronation	Non-event, but widely speculated to precede the elections
June	FOMC Meeting	We look for rate hikes

Source: DBS Bank

Joanne Goh

Credit: The valuation window for Asian high grade is narrowing

At the start of the year, our preferred trade in Asian credit was investing in BBB bonds, where valuations were attractive and we recommended a defensive position with expectation of volatility ahead. The pace of the rally in bonds during January has surprised us with several BBB bonds tightening around 50bp in spread terms (or USD3-5 in price). As a result, we now see valuations in the high grade space as beginning to look rich. We also note that recent new issues in the US BBB space have offered valuations close to Asian BBBs, with the average spread at pricing of 18 US deals being around 200bp, similar to Asian BBB deals. While the quasi-sovereign nature of many Asian credits and the higher BBB supply within the US investment grade partly explain this, it does indicate that Asian BBBs are no longer as cheap as they were a few weeks back. That said, we still see support for bonds at these levels in the near-term, especially with the Fed having delivered the ingredients for a risk-on rally. In fact, with interest rate risk becoming less of a concern now, we see extending duration as an option for some yield pick-up (the credit curve currently offers around 10bp pick up per year of extension). The longer duration bonds have already outperformed in January and we see this continuing in the near-term.



Source: Bloomberg, DBS

Neel Gopalakrishnan

Highlights of the week:

China: PMI highlights need for further policy support
Singapore: Singapore Budget 2019 – More room for expansion
Public spending to support growth
Singapore: Singapore Budget 2019 – Sustained support for firm level restructuring

Key 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	2.6	1.9	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

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