Economics & Strategy Weekly

China stimulus to the rescue?

DBS Group Research 15 February 2019

Taimur Baig
Chief Economist
taimurbaig@dbs.com

Ma Tieying
Economist
matieying@dbs.com

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

- *The global market recovery continues unabated despite a string of weak data points out of China, EU, and the US.*
- *In addition to expectations of some sort of resolution to trade wars and the US government shutdown, we think the market is betting on China stimulus to save the day.*
- *Tallying up various measures, the stimulus package is already impressively large, amounting to over 5% of GDP.*
- *Personal income tax cuts, increase in infrastructure spending, and reserve ratio cuts are already being implemented.*
- *Corporate tax relief and consumer incentives for white goods purchases are next in line.*
- *Given the debt burden, likely disruption from tech war, and relatively weak domestic sentiments, the stimulus may succeed in arresting growth slowdown for just a few quarters, in our view.*

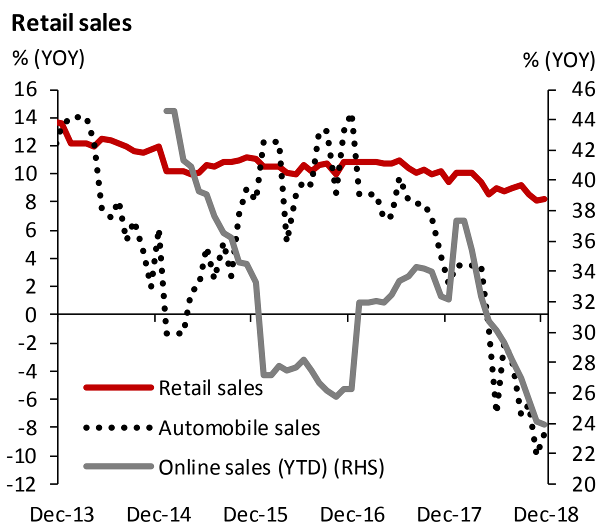
Hoping for the China stimulus to work

A year and a half ago, when the global economy was on a synchronised upturn, growth momentum was so strong that periodic bad news about China's slowdown or geopolitics was shrugged off by the markets. By contrast, just a couple of months ago, sentiment had become so poor that strong US labour market data or an easing of oil price was not sufficient to support the markets.

The pendulum has swung again in recent weeks, as the markets have been marching upward despite poor sales data worldwide, decline in earnings, and still no resolution out of trade wars or Brexit. Why such bullish sentiments? We think that not only is the market considering the US Fed to be its ally since the FOMC started making exceptionally dovish noise from December onward, expectations have soared that there will be some sort of resolution of trade wars and US government shutdown in the near term

But perhaps most crucially, there is renewed optimism about China, with equity flows surging and the markets rebounding. This is remarkable, considering the very poor dataflow out of the world's second largest economy. The latest trade data may have offered some solace, but that could be a one-off, and meanwhile data on sales, investment, and sentiment are very weak.

Sales look weak across a broad spectrum

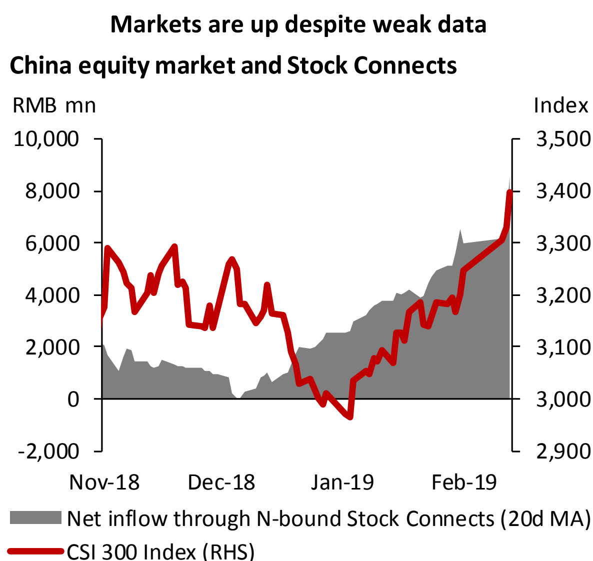


Source: CEIC, DBS

DBS

Markets are up despite weak data

China equity market and Stock Connects



Source: Bloomberg, DBS

So, then what gives? we think that global markets are betting on China stimulus to save the day. The hope is understandable, given that China has accounted for 30-40% of global growth in the past decade. As the economy has become bigger, its 6% growth today provides more value added than it did when growth was 12%.

Tallying up the various measures announced over the past year, the stimulus package is already impressively large, amounting to over 5% of GDP spread over 2018/19:

- Last year, the authorities raised the slabs for income tax thresholds, widened the scope for a number of deductions (e.g. for payments related to elderly care, health, and education), and introduced some efficiency enhancing tax administration measures.
- Infrastructure spending, financed by large scale issuance of special local government bonds, is being ramped up. USD120bn worth of rail projects (both over-ground and subway) were announced recently. Related to this, a special bank financing facility for the private sector has also been announced.
- The PBOC cut banks' required reserve ratio four times in 2018, and began 2019 with another cut. These cuts amount to releasing 3% GDP worth of liquidity to the economy.

We don't think the authorities are done yet. There have been concerted calls for corporate tax relief in recent years, and the authorities are very likely to respond to such demand this year, in our view. Local media has already reported that small-and-medium-sized companies are likely to get a number of relief measures, including higher income threshold for VAT payment, reduced corporate income tax rate for some qualified businesses, and lower social security contribution rates for employees.

Also, incentives to purchase home appliances and cars are in the pipeline. Such subsidies have been popular in the past, and considering the weakness in the retail sector, are critical to stop further worsening of sales.

While the authorities are unlikely to relax lending standards drastically and push for yet another credit bubble, the recent spate of measures reflect their desire to prevent growth from slipping below 6%. The authorities have certainly succeeded in impressing the markets, as reflected by the bullish price movements in recent weeks.

Our expectations are somewhat modest though. Given the already-high household and corporate debt burden, likely disruption from tech war, and relatively weak domestic sentiments, the stimulus may succeed in arresting growth slowdown for just a few quarters, in our view. Policy multipliers diminish as debt burden rises, as seen in the case of Japan in recent decades. The Chinese economy could well face similar headwinds, in our view.

Taimur Baig

Strategy

FX: Under pressure from deadlines and weak growth

Sentiment remains negative for the Australian dollar. Although the Reserve Bank of Australia does not support the market's view for a rate cut, it appears to have no problem with such expectation pushing the Oz lower to help the domestic economy. The RBA will only consider a rate cut if the unemployment rate reverses its downtrend from global slowdown risks deterring investment and hiring and falling home prices hurting household consumption. On the latter, the royal commission into misconduct of in the banking industry has tightened credit and will deter RBA hikes. Pay close attention to the AU 10Y bond yield where a break below 2% could drive AUD/USD below 0.70.

The Chinese yuan should not deviate far from 6.80 which we consider a neutral level for US-China trade talks. While both countries want a deal to ease trade tensions, they are far from reaching common ground on thorny issues such as forced technology transfers. The current negotiations in Beijing will determine if US President Donald Trump pushes out the trade truce deadline by another 60 days beyond the 1st of March. Beijing is expected, at the National People's Congress on the 5th of March, to lower China's 2019 growth forecast to 6-6.5%, and update its foreign investment laws to open its economy. Without an extension or a trade deal, US tariffs are set to increase to 25% from 10% on USD200bn of Chinese goods once the deadline lapses. If so, this will lift USD/CNY back up towards 6.96, the level from it fell at the start of trade truce in December.

The British pound is at risk from a disorderly Brexit or the UK exiting the EU without a deal on the 29th of March. With UK lawmakers divided and unable to find middle ground with Prime Minister Theresa May, EU leaders are not keen to renegotiate the withdrawal agreement or extend the deadline and would probably prefer the UK withdraw Article 50 instead. Under a no-deal Brexit, there will be no transition period. This will be an unprecedented event that would hurt an already slow Eurozone economy with possible disruptions to financial markets. Unlike the Brexit referendum in 2016, the sell-off in the pound will probably be felt more in the euro and other currencies this time around.

Philip Wee

Rates: More hurdles to clear

Even with the threat of another US government shutdown averted (Trump is poised to accept a deal on border security funding), there remain multiple hurdles for the market to deal with. These include the US debt ceiling (to be reinstated on 1st March, the ongoing China-US trade talks and the Brexit deadline (29th March). That said, news narrative is no longer largely negative. At the least, the self-inflicted slowdown on GDP growth should be limited to 1Q. Meanwhile, the market is also encouraged that Trump is willing to extend the 1st March deadline to raise tariffs on Chinese imports, suggesting that some form of a deal is likely to materialise.

We maintain that USD rates are too pessimistic on the US economy. Short-term rates are pricing in a 20% chance of a Fed cut by the end of the year and a full rate cut by end-2020. Powell's dovish tilt has already allowed financial conditions to ease as credit spreads tighten and stock markets rebounded. The risk of an overly aggressive Fed hurtling the US economy into a recession has fallen. As the hurdles clear, the removal of risk premium should lift USD rates across all tenors.

Meanwhile, we have tweaked our short-term SGD and HKD rates forecasts for 1H19. As noted yesterday (see Macro Strategy, 14th Feb 2019), Hibor and Sibor have been diverging from Libor as the Fed takes a back seat. Instead, local liquidity and fx factors have become more important in driving local rates.

	2019			
Singapore	Q1	Q2	Q3	**Q4**
3m Sibor	1.95	2.15	2.30	**2.30**
2Y	1.90	2.05	2.20	**2.20**
10Y	2.15	2.25	2.35	**2.35**
10Y-2Y	25	20	15	**15**
Hong Kong	Q1	Q2	Q3	**Q4**
3m Hibor	2.20	2.45	2.70	**2.70**
2Y	1.90	2.10	2.40	**2.40**
10Y	2.25	2.35	2.45	**2.45**
10Y-2Y	35	25	5	**5**

*2Y & 10Y are govvie yields
*% pa

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

Eugene Leow

Equities: Indonesia — Waiting for elections overhang to be removed

The JCI (Jakarta Composite Index) has gained 3.6% in local currency terms and 5.8% in USD terms year to date. **The market could take a breather after the recent strong gains but we expect more upside after the pullback.** The upcoming presidential election may not be a big risk factor but perhaps there could be more risks if the incumbent does not win and thus is now an overhang for the market. At current valuations, we think investors may want to wait for this overhang to be removed before further positioning instead of chasing at current levels.

Admittedly, compared to end of last year, we think the associated **currency gains (dollar perspective) from investing in JCI could be limited** now that the rupiah has recovered about 7% from last year's low. Our view that the USD may not be ready to turn weaker, and that the current account deficit is still a sore point for Indonesia, are valid considerations. **This could affect prospects of more fund flows to the market**.

Near-term drivers to hold up the major Consumer and Banking sectors are:

1. Domestic consumption is expected to benefit from the populist pre-elections approach and a pick-up towards the Lebaran festive season in 1H19;

2. The rebalancing of the LQ45 benchmark index from the change in the calculation methodology (from market capitalisation weighted to free-float weighted) should bode well for the banks. LQ45 is a common index used by the local institutions as a benchmark.

3. Owing to the single presence policy under Indonesian banking regulations, we believe M&A activities among the banks could be revived, especially as a couple of transactions had already taken place last year.

On a relative basis within the region, **Indonesia stands out as one with resilient domestic demand amid the global economic slowdown, and a prime beneficiary of lower oil prices and interest rates.** Indonesia's 2019 expected earnings growth of 11% is strong vs Asia ex-Japan's 4.4%. Potentially, should the Fed turn more dovish, USD weaken and US bond yields head lower, could result in stronger gains for the market.

Joanne Goh

Credit: Asian T1 CoCos have lower risk of non-call

Banco Santander's decision this week to not call one of its perpetual Tier 1 securities highlighted once again the risk in investors assuming that banks, as market practice, would call these securities on the first call date. Our analysis of Asian Tier 1 bonds callable in 2019 and 2020 shows that the risk of non-call is low at the moment due to two reasons 1. Limited economic incentive for the issuer not to call, unlike in the case of Santander and 2. Still favourable issuing environment for banks in Asia.

Of the seven CoCos (aggregating around USD10bn) callable in 2019 and 2020, all seven bonds would see an increase in coupon by an average of 0.9% from current levels (or 15% relative increase). Besides, the increased coupon would be quite similar (or even lower) to what the banks would need to pay for a new Coco if they issued one now. For example, the China Citic Bank 7.25% Tier 1 bond (Ba2 hyb) callable in 4/2019 would see the coupon step up to 8.1% if not called. The bank's 7.1% T1 bond callable 11/2023 is currently indicated at around 6.2%. Also, as a comparison, CMB Wing Lung Bank (Ba1 hyb) issued a Tier 1 bond in January this year at 6.5% with the bond now trading at a YTC (1/2024) of 6%. On the other hand, the coupon on Santander's 6.25% T1 (which it did not call) fell to around 5.6% (due to a decline in the benchmark EUR rate), and much lower than its current funding cost (the bank issued USD1.2bn of T1 notes at 7.5% on 6 February). Hence, unlike in the case of Santander, the Asian banks do not have an economic incentive to not call their T1s at this time.

We believe the non-call incident has reminded market participants of the flawed assumption that banks would call their capital securities at the first opportunity, irrespective of economic considerations. Whereas in reality, banks are under no contractual obligation to redeem the bonds and the call is an option that they may choose to exercise. The argument of reputational damage in the event of non-call will not hold, especially as not calling bonds becomes more common. Banks that have previously chosen to extend capital bonds have been able to access the markets fairly soon after, indicating no lasting reputational damage. Investors, instead, have to adequately price in the risk of extension at the time the bonds are priced.

Neel Gopalakrishnan

Highlights of the week:

Rates: The SOFR transition
Election watch in India, Indonesia and Thailand: Plenty of drama, but market implication largely neutral
SGD rates: The SSB swing factor
Japan: Three key growth challenges

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	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	2.5	1.6
Philippines**	6.7	6.3	6.5	6.4	2.9	5.2	3.9	3.8
Singapore	3.6	3.4	3.0	2.8	0.6	0.4	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	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.8	1.8	1.5	1.8	1.4	1.4
Japan	1.9	0.7	0.7	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	6.25	6.00	6.00	6.00	6.00	6.00	6.00	6.00
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

Group Research

Economics & Strategy

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

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

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

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 68782072 neelg@dbs.com

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

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

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

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

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

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

Disclaimer:

The information herein is published by DBS Bank Ltd and PT Bank DBS Indonesia (collectively, the “DBS Group”). It is based on information obtained from sources believed to be reliable, but the Group does not make any representation or warranty, express or implied, as to its accuracy, completeness, timeliness or correctness for any particular purpose. Opinions expressed are subject to change without notice. Any recommendation contained herein does not have regard to the specific investment objectives, financial situation & the particular needs of any specific addressee. The information herein is published for the information of addressees only & is not to be taken in substitution for the exercise of judgement by addressees, who should obtain separate legal or financial advice. The Group, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if the Group or any other person has been advised of the possibility thereof. The information herein is not to be construed as an offer or a solicitation of an offer to buy or sell any securities, futures, options or other financial instruments or to provide any investment advice or services. The Group & its associates, their directors, officers and/or employees may have positions or other interests in, & may effect transactions in securities mentioned herein & may also perform or seek to perform broking, investment banking & other banking or financial services for these companies. The information herein is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation. Sources for all charts & tables are CEIC & Bloomberg unless otherwise specified.
DBS Bank Ltd., 12 Marina Blvd, Marina Bay Financial Center Tower 3, Singapore 018982. Tel: 65-6878-8888. Company Registration No. 196800306E.
PT Bank DBS Indonesia, DBS Bank Tower, 33rd floor, Ciputra World 1, Jalan Prof. Dr. Satrio Kav 3-5, Jakarta, 12940, Indonesia. Tel: 62-21-2988-4000. Company Registration No. 09.03.1.64.96422.