Real Interest Rates in Asia: Room to Ease

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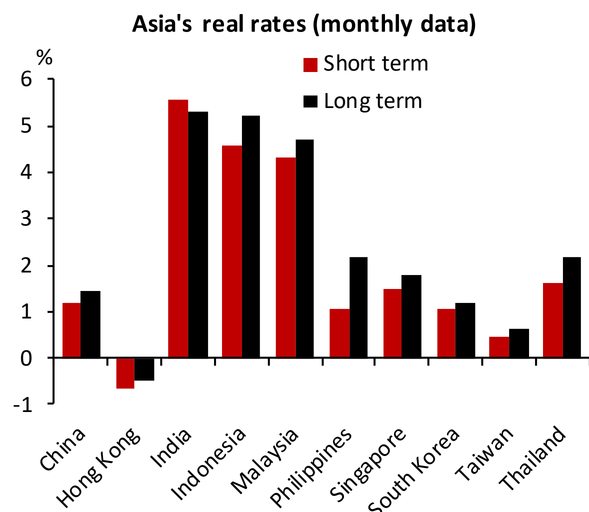
- *Inflation rates have eased faster than bond yields, pushing up real rates in some Asian economies*
- *This has been the case both at the short-and-long end of the yield spectrum*
- *Central banks in India, Indonesia, and the Philippines will likely dabble in rate cuts to lower real rates.*
- *Financing and currency concerns, geopolitical uncertainty, and volatile investor sentiment will likely get in the way of a major policy easing cycle, in our view.*

Asian real rates have room to fall

Global financial conditions have improved dramatically in the last couple of months, with spreads compressing, yields falling, equity prices rallying, and capital deployment jumping. In contrast, curves are still flat, economic data remain poor, and there are no shortages of geopolitical uncertainties. With the impetus to follow the Fed dissipating and inflation at bay, real interest rates in select parts of Asia could do with some easing.

Below we plot short-term (using the difference of latest 3-month treasury yield and CPI inflation rate) and long-term (10-yr bond yield minus inflation) real interest rates in Asia. They are not apples to apples comparisons in some cases, given that the data span low and high inflation cases, as well as low and high debt economies. Still, it is instructive to see short-term real rates look strikingly high in India, Indonesia, and Malaysia. In the cases of Philippines and Thailand, the gap between real short-and-long-term rates look rather considerable as well. From a policy perspective, this would suggest, especially in the cases of India and Indonesia, perhaps some room for easing.

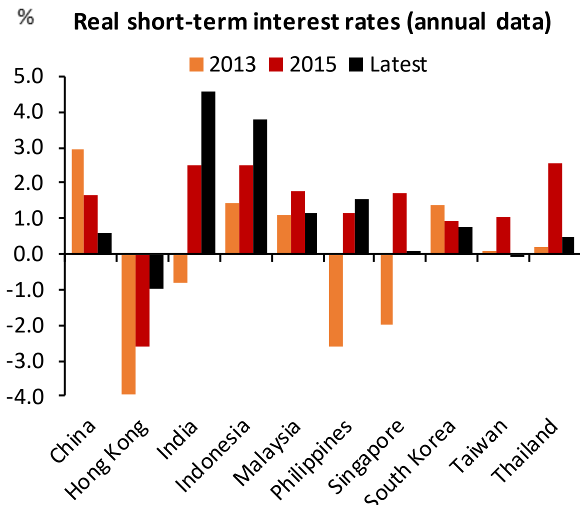


Source: CEIC, DBS Group Research
Notes: Data available till January'19 for all countries

The main reason for this outcome is a bout of rather dramatic disinflation in some countries, particularly Malaysia, where CPIyoy% is now in negative territory. Whatever easing of bond yields have taken place lately,

that has been outpaced by disinflation. If oil prices stay in the USD50-60 range this year, and trade tariffs stop playing a distortionary role, inflation will likely remain well-behaved this year, giving central bankers the confidence to pursue some easing measures.

Looking at the data from a low frequency angle, we perhaps get a truer picture. In the following two charts, the historical annual calculations for real rates are done using annual average inflation and year-end bond yield rates figures (and the latest data point is the difference between the early-March yield and 2019 inflation forecast made by DBS economists). They show that short-term and long-term rates have climbed steadily in India and Indonesia in recent years, whereas they have eased in China, South Korea, and Thailand.

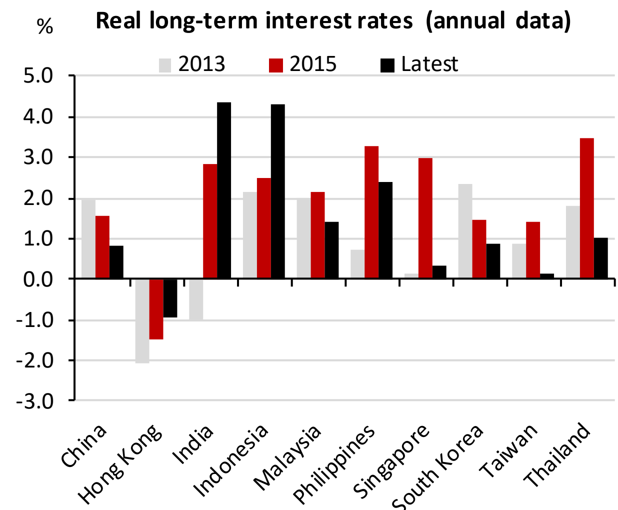


Source: CEIC, Bloomberg, and DBS Group Research. Real rates calculated by taking the difference between end-year 3-month treasury yields and average annual inflation. For latest, 2019 annual inflation forecast is used.

Along with the ongoing fiscal stimulus, China's PBOC has been easing monetary policy for a while, and that has been picked up in the real rates figures. The authorities in the Philippines may want to follow suit as well, as we think there is scope for somewhat lower short-and-long-term real rates.

In India, the central bank turned dovish a few months ago, and we expect further dovish moves by the RBI. With respect to Indonesia, BI may well be inclined to ease rates this year, having been at the forefront of tightening policy last year.

We don't expect a prolonged easing cycle though. While late cycle dynamics are prevalent, there is scope for volatility to rebound, which could require defence of currencies and shoring up buffers. Financing and currency concerns, geopolitical uncertainty, and volatile investor sentiment will likely get in the way of a major policy easing cycle in Asia, in our view.



Source: CEIC, Bloomberg, and DBS Group Research. Real rates calculated by taking the difference between end-year 10-yr treasury yields and average annual inflation. For latest, 2019 annual inflation forecast is used.

Taimur Baig

Eurozone: ECB turns a dovish hue

The European Central Bank (ECB) caught up with the economy's evolving reality of slowing growth and easing inflation. With growth falling below the post-quantitative easing quarters and inflation likely to follow suit, the central bank opted to frontload measures. Importantly this contrasts with the decision to cease QE two months back.

The ECB's tone was cautious. They expressed fears that the economy might remain stuck in a "period of continuous weakness and pervasive uncertainty" this year. Staff GDP forecasts were cut sharply – growth is now seen at 1.1% in 2019, 1.6% in 2020 and 1.5% in 2021. This compares to December's outlook for growth at 1.7% in 2019 and 2020. They retained the guidance that risks to the growth outlook are "still tilted to the downside", owing to geopolitical uncertainties (including Brexit), protectionist threats and slowing emerging markets.

Despite this, the ECB holds on to expectations that the slowdown will be temporary and improve in 2H19, pointing to a strong labour market, better loan growth, higher fiscal spending and easing domestic idiosyncratic factors, that particularly hurt German industrial activity last year.

Inflation forecasts were also lowered – now seen at 1.2% in 2019, 1.5% in 2020 and 1.6% in 2021. This compares with 1.6% for 2019 and 1.7% for 2020 in December. Core inflation forecasts were lowered by 20bps across this year and next. A concurrent revision in underlying oil price assumptions also underscored their benign view on cost-push forces. This inflation outlook suggests that the ECB expects inflation to remain below the 2% target even in the medium-term.

This cautious economic assessment was accompanied by four measures, few new while others reaffirmed their policy bias.

- The forward guidance on rates was changed to "interest rates will remain at their present levels at least through end-2019", from the earlier "through the summer of 2019". Separately, the ECB chief suggested that few of the Council members backed a pause into March 2020

- ECB will continue to reinvest proceeds of bonds maturing under the just-concluded QE program, "in full" and "for an extended period of time".

- **New round of Targeted Longer-term Refinancing Operations (TLTROs-III)** were unveiled, starting in September 2019 and ending in March 2021. These will be rolled out quarterly, based on the main refinance rate (not the deposit facility rate) and with a two-year maturity. Further details will be announced closer to the date. These will help preserve favourable lending conditions and ensure transmission of an accommodative monetary policy. The previous two rounds of TLTROs were announced in 2014 and 2016.

- The existing ECB lending operations will continue as fixed rate tender procedures with full allotment at least until March 2021.

Policy outlook: Yesterday's measures were not a big surprise, but the timing of the announcement was. The decision to be ahead-of-the-curve was likely a step to reverse any unwarranted tightening in financial conditions. Policy normalisation plans are on ice (see here), with no rate hikes likely beyond the ECB President Draghi departure from office in 4Q this year. In fact, this marks the only instance when the head of the central bank ends his tenure without any rate hikes.

While the funding support might cap any increase in funding costs, it does not alleviate the main risks for the Eurozone outlook, i.e. external developments – overhang of US auto tariffs, slowing global growth particularly in China, and Brexit developments. This also suggests that any severe downturn in the second half of the year might necessitate new and unexplored policy responses.

The ECB's dovish turn pushed the EUR/USD decisively below the pre-normalisation trading range of 1.15-1.25, along the expectations of our DBS Currency FX Strategist. The next target at 1.10 beckons.

Radhika Rao

Strategy

FX: Haunted by global growth worries

Hopes for the US and China seal a trade deal this month are no longer buoying the Chinese yuan and risk appetite. It has become evident that global trade tensions will not go away and simply shift to other countries. US-Eurozone trade tensions are simmering over America's intentions to hit car imports with tariffs. The US plans to withdraw India as a beneficiary developing country under the Generalized System of Preferences program.

Instead, global economic slowdown worries have returned to haunt currencies. The Chinese yuan has started to depreciate again after the National People's Congress announced a slower 6-6.5% growth target for 2019. China reiterated its pledge to increase yuan flexibility which has been in place after the yuan's one-off devaluation in 2015 and keeping USD/CNY aligned with the USD Indices, especially the one for emerging Asian currencies. Given our view that the US dollar is relatively strong, we have not abandoned the risk for the yuan to depreciate to 7 this year.

The impact of China's slowdown was evident in Australia where GDP growth has further decelerated to 2.3% YoY in 4Q18 from 2.7% in the previous quarter. This was well below the Reserve Bank of Australia's latest 2.75% growth forecast for 2019 which was revised down from 3.25% last month. Hence, there will be pressure for the Australian dollar to depreciate below 0.70 on belief that the RBA is behind the curve and needs to cut rates.

Our long-held call for a lower euro on weaker Eurozone fundamentals is playing out. The European Central Bank (ECB) has slashed this year's growth forecasts to 1.1% from 1.7% previously, and inflation to 1.2% from 1.6%. The ECB has abandoned its intentions to hike rates later this year and launched a fresh round of targeted longer-term refinancing operations. Apart from the threat of US auto tariffs, the Eurozone economy is also at risk from increased prospects for a disorderly Brexit. We remain committed to our view for EUR/USD to fall below 1.10 this year.

Philip Wee

Rates: Global growth worries

G10 interest rates did not bounce despite the improvement in risk sentiment since the start of the year Weak data out of the Eurozone, Japan (and much of the globe), has led to significant re-pricing of monetary policy for the year ahead. Rate hike expectations for the European Central Bank (ECB) are now pushed deep into 2020 while 10Y JGB yields remain sticky around zero despite a less aggressive purchase schedule from the Bank of Japan (BOJ). **The average 10Y yield across the G10 economies now stand at 1.20%,** down by 34bps since the start of November. **The rally is ubiquitous across all ten economies with the commodity-linked ones (AUD, NZD and CAD) registering the sharpest yield declines.** The upshot is that G10 rates generally pricing in easing across the DM space. Even the US is not spared, with the market looking at a cut by end-2020.

Lower DM yields provide a constructive backdrop for Asia govvies. With the DM central banks largely on pause or contemplating further easing, policy makers across the EM economies (including Asia) have been handed a much-needed breather. At the least, Asia central banks have more leeway to keep rates on hold at a time when CPI numbers are low and growth is uninspiring. With real rates still high, there appears to be room to reduce interest rates across some Asian economies (India, Indonesia, Malaysia and the Philippines). India has already cut rates. Speculation that other central banks would follow suit is inevitable**. That said, the environment is not as benign as 2017 when the USD was weak**. Currently, the US economy is still relatively strong amongst the DM, keeping the USD firm. Interest rate differentials still bear watching even if the Fed is on pause.

In the immediate term, with risky assets looking stretched to the upside and USD strength ascendant, **we have closed out our long 3Y Indo govvie idea.** It would probably require better economic data and resolution on the China-US trade talks before risky assets make another leg higher.

Running ideas:

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

Eugene Leow

Equities: KLCI target trimmed on lacklustre earnings

The KLCI (Kuala Lumpur Composite Index) has turned out flat for the year and underperformed the region's 10% gain. We believe the main reasons behind the underperformance is the lack of earnings growth and relative expensive valuation versus the region.

Following the lacklustre 4Q18 results season, we trim our FBM KLCI earnings growth for 2019 and 2020 to 2.0% and 7.1% respectively, compared to our previous projections of 4.6% and 8.2%. The main reasons for the cuts are largely from telecommunication companies (heavy costs), banking (tepid outlook guidance) and utilities (impact of incentive-based regulation). Companies are generally less upbeat about the outlook for 2019, which continues to be affected by external macro headwinds as well as intensifying competition in the local market where margin compression remains a key concern. Incorporating our latest earnings revision, we trim our FBM KLCI target to 1735 (from 1800), based on 16x earnings.

Further re-rating catalysts for the market will hinge on economic conditions in 2H19 which, unfortunately, are expected to stay subdued. We remain hopeful that the current fiscal reforms, initiated by the Pakatan Harapan-led government such as targeted fuel subsidies, gradual increment of minimum wage and tax refunds to the private sector will boost private sector spending. However, these initiatives may take some time to bear fruit. We project 2019 full-year gross domestic product (GDP) growth of 4.5% (2018: +4.7%) as we are mindful of lower government spending and slowing growth in the manufacturing and mining sectors. Domestic demand remains the key growth driver for the Malaysian economy. Stable employment and wage growth will continue to be supportive of private consumption which has remained the country's largest economic growth contributor.

Despite being less positive in the market versus the region, we see opportunities in high-quality names that have resilient earnings and are less susceptible to the adverse effects of government policies.

Joanne Goh

Credit: Liquidity supportive of EM credit markets

Recent order books on new bond issues indicate that there is a large amount of liquidity looking for yield. Hence, while bond valuations are turning rich, the amount of liquidity remains supportive of these valuations, and will also likely limit the extent of declines during sell offs, especially in high quality credits. This is despite concerns over whether markets may have turned too optimistic over interest rates and other risks such as trade talks, as we have highlighted before.

Qatar returned to the primary market on 6 March with a jumbo USD12bn three tranche deal. The order book was a staggering USD50bn (around 30% of the GCC state's GDP!). A good credit (AA- rated) with the right pricing did the trick for this deal (Qatar issued its 5Y at T+90, 10Y at T+135 and the 30Y at T+175). Saudi Arabia based Almarai (BBB- rated) issued a USD500mn bond last week with the book covered around 9x.

Outside the GCC, recent new issues have shown healthy order books, though of a much lower magnitude than Qatar and Almarai. Investment grade issues like ICBC Financial Leasing, Exim Bank of India and Vanke reported books that were on average around 3x covered while three BB- issuers from India and Indonesia reported an average book cover of 2.5x. While the order book data reflects investor preference for higher quality issuers, there were outliers with some short-dated but high yielding Chinese single B or unrated issues reporting books that were 7-8x covered. These are the kind of trades where we would exercise caution.

Neel Gopalakrishnan

Highlights of the week:

Hong Kong – Core of the Greater Bay Area
Malaysian Bonds: Fiscal concerns easing
India: US considers withdrawal of trade concessions
USD rates: Pause, not stop
South Korea & Taiwan: lower inflation, stable rates
China rates and credit: Unearthing value

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018e	2019f	2020f	2017	2018e	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	3.9	3.2	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	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	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	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.5	1.5

* 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	0.00	0.00	0.25	0.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00
United States	2.50	2.50	2.75	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	6.90	7.00	7.10	7.05	7.00	6.95	6.90	6.85
Hong Kong	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
India	72.0	73.0	74.0	73.5	73.0	72.5	72.0	71.5
Indonesia	14200	14600	14800	14700	14600	14500	14400	14300
Malaysia	4.10	4.20	4.30	4.25	4.20	4.15	4.10	4.05
Philippines	53.0	54.0	55.0	54.5	54.0	53.5	53.0	52.5
Singapore	1.38	1.40	1.42	1.41	1.40	1.39	1.38	1.37
South Korea	1140	1160	1180	1170	1160	1150	1140	1130
Thailand	32.0	33.0	34.0	33.5	33.0	32.5	32.0	31.5
Vietnam	23200	23300	23400	23350	23300	23250	23200	23150
Australia	0.70	0.68	0.66	0.67	0.68	0.69	0.70	0.71
Eurozone	1.10	1.08	1.06	1.07	1.08	1.09	1.10	1.11
Japan	111	113	115	114	113	112	111	110
United Kingdom	1.26	1.24	1.22	1.23	1.24	1.25	1.26	1.27

Australia, Eurozone and United Kingdom are direct quotes

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