Economics & Strategy Weekly

View from Europe — a tentative trough

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- *In our meetings with clients in Frankfurt and London this week, we have detected tentative optimism about the outlook, notwithstanding a negative dataflow*
- *Europe has its fill of formidable challenges ahead*
- *Independent of the Brexit outcome, uncertainties will linger with respect to UK-EU trade and investment*
- *Economic and financial distress in Turkey could affect the region*
- *If China stimulus fails to add further momentum to imports, Europe's upside will be limited*
- *Trade negotiations with the US will be challenging for Europe*
- *As will the ongoing spat over NATO defence*

Europe and UK: A tentative trough

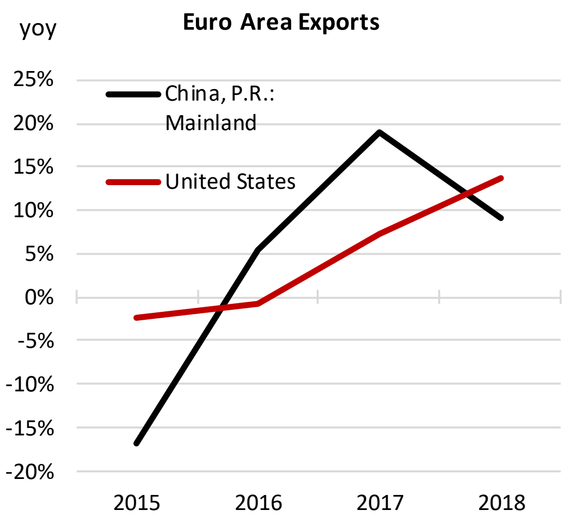
With endless Brexit intrigue and considerable volatility around Turkey, European investors are a busy lot these days. Add to this a stream of weak industrial data from Europe's largest economies, questions about US-Europe trade friction, debate over NATO defence spending, and hope for China stimulus to help exports, macro themes dominate overwhelmingly.

During our meetings with Europe and UK-based investors this week, we sensed guarded optimism that improving financial market conditions (as bond spreads have narrowed and equity prices climbed this year) and a likely pick-up in demand from China would put Eurozone's worst behind in 1H19. The search for yield in emerging markets continues unabated and there was particular interest in Asian high yielding economies like India, Indonesia, and the Philippines, along with many questions on frontier markets like Bangladesh, Sri Lanka, and Vietnam.

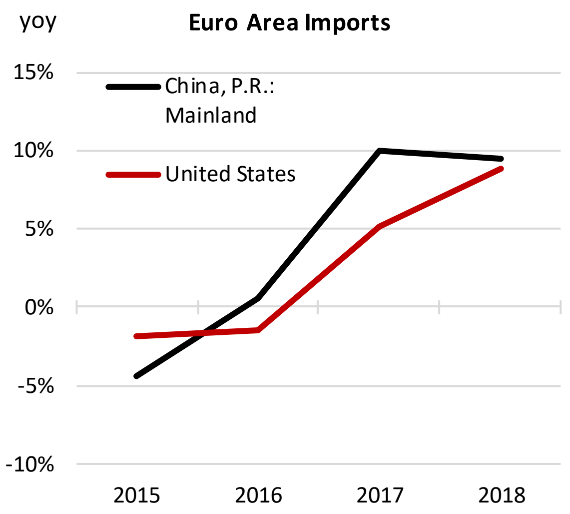
There was however an interesting line of thought that low yielding, more developed, Asian economies have a structural headwind brewing. This relates to a gradual opening up of China's debt markets, alongside inclusion in global bond Indices. Investors are seeing considerable demand among their peers, including talk of how eventually Chinese risk free rates will converge to US Fed rates. As China's current account heads to zero or negative territory, thus creating an organic pull for global portfolio flows, the question is if that would crowd out some EM investments.

We think that high yielding Asian economies still have sufficiently positive real rates to offer attractive risk-reward propositions to global investors. We are however not as sure about the fixed income papers offered by the likes of Malaysia, South Korea, Taiwan, and Thailand. We consider Hong Kong and Singapore as special cases in this comparison due to their status as financial centres, but for the four other economies mentioned above, the coming years may entail more intensified competition for global fixed income funds.

European investors are concerned about economic and financial market distress in Turkey. While not a part of EU, Turkey is a major trading partner of many European economies, and the demand destruction there in the past year has been felt acutely by the regional exporters. Behind economics and finance, the geopolitical spillover from possible turmoil in Turkey could be considerable for the region.

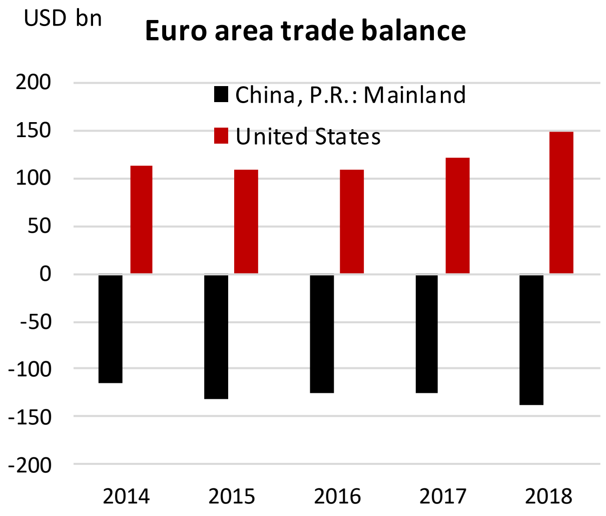


Source: Eurostat, DBS



Source: Eurostat, DBS

Additional cloud over the horizon relates to the US. European auto industry is anxious about the threat of tariffs; many countries are facing pressure from the US on their dealings with China and Iran; there is also renewed pressure on greater contributions to NATO budget.



Source: Eurostat, DBS

With plenty of headache from the US these days, hope lies with China. Fixed income and FX investors are busy taking positions on Chinese debt and currency. Funds are increasing their allocation to China as access and products become available. Analysts are tracking the efficacy of China stimulus as minutely as they cover European and US data. This is particularly important as there are good reasons to believe that the China stimulus will be more consumption (and less investment) focused this time. Hence the likely impact on global commodity and machinery demand may well be less so than a similar-sized stimulus of the past would have achieved. If China's stimulus fails to add further momentum to its imports, Europe's upside (through its exports channel) may well be limited.

Taimur Baig

India: RBI leaves door open for another neutral cut

The Reserve Bank of India (RBI) monetary policy panel cut the repurchase rate by 25bp to 6.0% at its second successive rate review on Thursday. This unwound the cumulative 50bp hikes in 2018. Policy stance was left unchanged at 'neutral', along our expectations, which reflected the committee's bias to remain data-dependent and non-committal on the path, given interim uncertainty. The vote to change the rate saw a 5-2 split, with Chetan Ghate and Viral Acharya casting the dissent votes to keep rates unchanged.

Economic assessment: **The central bank lowered its growth and inflation projections.** The outlook suggests the central bank expects inflation to stay below 4% in FY20, with 1H pace cut to 2.9-3% and 3.5-3.8% in second half of the year. For FY21, the base case assumes inflation at 3.8-4.1%. Our forecasts are for inflation to average 3.5% in FY19 and 3.8% in FY20. For this year, while risks are balanced, while the bank highlighted these headwinds: a) crude oil price direction; b) fiscal slippages at the general government level; c) El Nino risks in 2019. If monsoon is deficient, the RBI foresees 30bp downside risk to growth in FY20 and 50bp increase in inflation vs its baseline; d) sharp and unexpected rebound in food prices (see second box for underlying assumptions).

On growth, the central bank lowered its forecast to align with the statistics agency, with FY20 GDP growth seen at 7.2%; which breaks down to 6.8% in 1Q, 7.1% in Q2, 7.3% in Q3, and 7.4% in Q4. For 2020-21, real GDP growth is seen in the region of 7.3-7.5%.

Moderating inflationary expectations to comfort the RBI

The RBI also took comfort from ongoing moderation in inflationary expectations, which have evolved favourably in recent months. Prior to the switch to an inflation-targeting framework, inflationary expectations were stubbornly elevated and unanchored, particularly between 2009 and 2013 (see chart). This was a period when high food prices prevailed, and monetary policy was accommodative, leaving real rates in negative. Elevated inflationary expectations saw supply shocks swiftly morph into second-order effects, spilling over as generalised pressures and feeding into wage decisions.

Since the inflation-targeting framework was adopted, trends have turned favourable. For FY19, inflationary expectations have moderated, given their adaptive nature, owing to strong disinflation in the food segment, while monetary policy was tight, leaving real rates in positive territory. Three-month ahead inflation expectations in the March 2019 round were lower by 160 bps vs September 2018. One-year ahead inflation expectations softened by 170 bps between the two rounds. This is likely to leave policymakers with more confidence that, notwithstanding supply shocks, reducing rates might not necessarily feed into inflationary risks in the short-term.

Policy guidance

Policy guidance was not as dovish as markets expected. This explained the kneejerk disappointment in the 10Y INR bond yields and rupee price action. That the stance was maintained at 'neutral' underscores our expectations the committee prefers to stay data-dependent, but with a dovish bias. Downward revisions in economic projections coupled with remarks that the 'the output gap remains negative' and the need for 'domestic growth impulses' suggest that the door remains open for further policy easing. **We expect another rate cut, with June as our base case. An argument for the cut to be delayed to August is equally strong if the RBI sees reason in factoring in the full-year budget due in July and awaits a clearer picture on monsoon developments.** Barring a move in carving out an additional 2% from the Statutory Liquidity Ratio (SLR), there were no fresh moves aimed at liquidity or jumpstarting policy transmission.

Radhika Rao

FX: CNY and GBP have been flat, awaiting resolutions to trade tensions and Brexit

The Chinese yuan has not deviated far from 6.70 vs the US dollar since February. Hope for a US-China trade deal was reflected in the Chinese stock market rally; the Shanghai Composite Index has so far risen more than 30% this year. The better-than-expected PMI, which rose to 52.9 in March from 50.7 in the previous month, gave rise to optimism that the stimulus measures may be stabilizing the economy. This, however, does not imply that China's growth would stop slowing. Consensus expects **China's GDP growth** (data out on April 17) **to slow to 6.3% YoY in 1Q19** from 6.4% in 4Q18, in line with the government's lower 6-6.5% growth target this year. China's stimulus measures are aimed at cushioning growth by targeting demand to offset the supply-side pressures on the trade front. At last count, US President **Trump warned that trade talks are likely to continue for another four weeks**. There are some expectations that Trump-Xi summit could come as late as the Osaka G20 Summit on June 28-29 to ink a trade deal. Any yuan appreciation from 6.70 will, however, need an agreement to roll back some of last year's tariffs.

The British pound has been holding a 1.30-1.33 range against the USD since February 19. The level above 1.30 represents hopes for the UK to avert a disorderly Brexit. This has so far taken the form of the UK House of Commons delaying the Brexit date by rejecting a no-deal Brexit outcome. Having agreed to UK's request for a first delay to April 12 from March 29, the **EU needs UK lawmakers to support the thrice-rejected withdrawal agreement for a second delay to May 22**. It remains to be seen if Prime Minister May can find a compromise with the opposition Labour Party to support her deal in a fourth vote. A backlash from her Conservative Party cannot be ruled out. A longer delay would require the UK to participate in the EU Parliament elections scheduled for May 23-26 but Brussels would need clarity if more time will be needed for a second referendum or new elections for a Brexit rethink. These are hard questions that the UK needs to answer by the EU Summit on April 10. Until then, **the legal default remains for the UK to exit the EU without a deal**, which in turn, keeps open the risk for the pound to fall below 1.30.

Philip Wee

Rates: DM yields pull back from brink

There has been a notable rebound in developed market yields since the low registered on March 27. 10Y US Treasury yields are some 15bps off lows. Similarly, the average 10Y yield of G10 (ex US) economies has risen by 12bps over the same period. As it became clear that convexity hedging may have exacerbated the move to the downside, it became difficult for yields to push any lower when Chinese PMIs came in much stronger than consensus expects. The market has been quick to react to this piece of positive news. While a single month of data is probably inconclusive, it does seem that global slowdown risks may have abated somewhat as Chinese stimuli start to take effect.

Improving sentiment on the Brexit front probably helped. Aside from dismal economic numbers, uncertainties over the Brexit outcome has kept German Bund and UK Gilt yields depressed. The UK Parliament has approved a bill that would prompt May to seek an extension from the European Union if a deal is not struck by April 12. The market has since placed higher odds of an extended delay, lifting 10Y Gilt yields to 1.08%. This has considerable spillover unto European government bonds as well as US Treasuries. With the Brexit deadline just over a week away, brace for further volatility ahead.

In China, the stock market bounce and improvement in data have finally dragged govvie yields higher. Thus far, the selloff has been concentrated in the longer tenors (5Y, 10Y) but the shorter tenors (<3Y) have been relatively resilient. At this point, we still think that further monetary stimulus is likely, but may be less aggressive than previously thought. Short-term rates should still stay relatively anchored. **The 3Y/10Y segment of the curve already looks steep and we are wary of chasing further. It appears more likely that the curve would level-shift modestly higher in the coming few months.**

Key ideas:
-long 5Y India govvie (Mar 26, lcy terms)
-long 5Y Indonesia govvie (Mar 26, lcy terms)

Eugene Leow

ETF Equities: Flows returned to US assets, especially US fixed income, amid global uncertainties

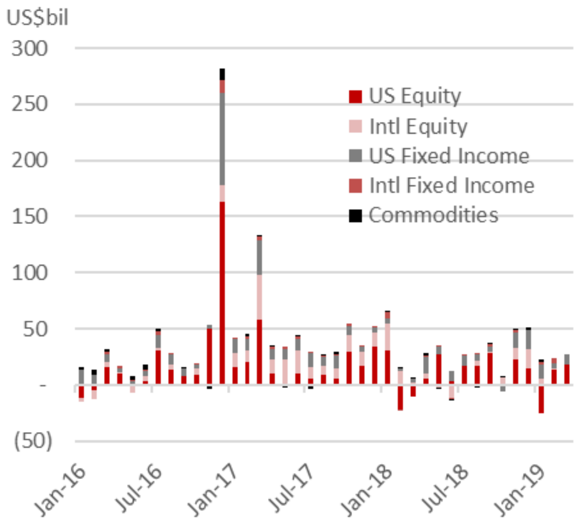
Following an outflow in January, flows to US-listed ETFs returned in February and subsequently picked up in March, with the quarter's flow ending in positive territory. **However, total net flow for the quarter was lower compared to Q1 last year and was a far cry from 2017's Q1 flows.** Investor sentiment was affected by a deteriorating growth outlook, rising macro risks arising from monetary policies and geopolitics.

During the quarter, **flows into US fixed income ETFs were the strongest among all the asset classes**. They attracted US$27.1bn out of US$46.1bn inflows or 59% of total inflows. Diminishing likelihood of rate hikes and falling bond yields amid rising global slowdown concerns have pushed investors to seek refuge in bonds. US 10-year bond yields fell 28bps from 2.69% to 2.41% during the quarter. **We believe the shift to bonds is likely to continue** as long as slowing global growth remains a concern, pushing global central banks to take it easy on monetary policies and hence bond yields lower.

The flight to quality was also obvious in the form of flows away from international assets in March. **Flows to International equities and fixed income were almost flat to negative respectively.** We think a stable USD outlook is the reason for investors to still prefer US assets. Moreover, among developed markets (DM), the growth outlook for Japan and Eurozone have deteriorated more than the US' and yields over there are close to zero or negative. And in emerging markets (EM), valuations are not attractive from a risk-reward perspective after the strong performance earlier in the year.

We forecast flows to still prefer the US assets, and the rising probability of Fed rate cuts and recession may see investors continue to seek refuge in US bonds. Meanwhile until valuations are deemed more palatable, flows are unlikely to return to EM in a big way.

Monthly flows of US-listed ETFs



Source: ETF.com. As of March 2019.

Joanne Goh

Asian Credit: Volume and variety, but limited value in new issues

The Asian primary credit market over the past two weeks has offered more variety in terms of deals to look with several issuances ex-China (especially Indian issuers). Issuances out of the Middle East also picked up and the jumbo USD10bn issue from Saudi Aramco will be in focus next week. However, as with the secondary market, value has been hard to find among the new issuances with 5Y investment grade credits generally pricing in the high 3% area and 5Y BB rated names in the low 5% area. We believe these valuations were close to fair value (in the current market) or even lower than fair value but the bonds were well bid in secondary, reflecting the strong market sentiment.

The change in sentiment is best captured by the fact that an issuer rated B- and with a recent restructuring history, was able to tap the market for a USD440mn deal and perform in the secondary market. More evidence that markets have a short memory and are forgiving. Another case in point is a 10Y bond issued by a gaming company essentially for project finance was priced in the high 4% area, very low for project risk in our view. In weaker markets, participants may well have asked more questions about project risk than going by the strength of the parent company's fundamentals.

As we wrote in the Monthly dated 29 March, we believe caution is warranted with valuations getting rich. A selective approach to adding risk or even taking a pause does not hurt. That said, barring significant global events, we see valuation support in the short term solely based on liquidity in the system. In the weekly dated March 22, we had talked about the around 10% increase in AUM of large Asian funds in the first two months of the year. Over the past month, anecdotally we hear of sizeable fund raising by private banks for discretionary bond funds.

Neel Gopalakrishnan

Highlights of the week:

Asia equities: Another volatile month ahead
Chart of the Week: Tech war and electronics supply chain relocation: who could benefit?
Macro Insights video: From trade war to tech war
SGD Flash: No urgency to tighten SGD policy
India: RBI leaves door open for another neutral cut

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	3.5	3.8
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	1.7	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	1.0	1.3
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	5.75	5.75	5.75	5.75	5.75	5.75	5.75
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**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
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	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50

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

Exchange rates, eop

	Mar 29	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.73	6.85	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.4	70.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14244	14300	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.10	4.20	4.25	4.20	4.15	4.10	4.05
USD/PHP	52.7	54.0	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.35	1.37	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1137	1135	1145	1140	1135	1130	1125	1120
USD/THB	31.8	32.5	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23202	23250	23300	23280	23300	23250	23200	23150
AUD/USD	0.71	0.70	0.68	0.68	0.68	0.69	0.70	0.71
EUR/USD	1.12	1.12	1.10	1.11	1.12	1.13	1.14	1.15
USD/JPY	111	113	115	114	113	112	111	110
GBP/USD	1.31	1.30	1.28	1.29	1.30	1.31	1.32	1.33

Australia, Eurozone and United Kingdom are direct quotes

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