Economics & Strategy Weekly

Don't dismiss inflation

DBS Group Research

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- *A running theme at the ongoing IMF meetings is the policy room available due to the lack of inflation.*
- *The inability to hit the 2% inflation target despite unprecedented monetary easing by the Fed, ECB, and BoJ is indeed striking.*
- *Many idiosyncratic, structural, and cyclical factors are playing into the subdued inflation narrative. They include aging, China's economies of scale as the supplier of most of the world's manufactured goods, lack of pricing power among retailers due to competition from e-commerce, muted wage growth, well-anchored inflation expectations, and no major spikes in commodity or food prices in the past decade.*
- *Looking at the data, we are however not convinced that low inflation is a permanent fixture of the global economic landscape.*

Can muted inflation last?

The inability of G3 central banks to generate 2% inflation on a sustainable basis, despite unprecedented fiscal and monetary support over the past decade, is under renewed focus. Should the ECB forget about rates normalisation and engage in further QE? Should the Fed send out further dovish signals by entertaining "average" inflation targeting over the cycle? Should the BoJ monetise debt in an even more explicit manner? These questions are being heard in the panels and side-lines of the ongoing IMF/World Bank Spring meetings in Washington DC.

There is consensus that reasons behind muted inflation are many. They include idiosyncratic (rise of e-commerce), structural (aging), and cyclical (output and employment gap in Europe) factors. Inflation expectations are low, and central banks' credibility to lift them is under threat. Moreover, because of a lack of pricing power (thanks to the competitive pressure from the likes of Amazon and Wall Mart), a rise in input price or wages does not readily materialise in retail price increases. Typical sources of headline inflation shock, food and fuel, have had their ups and downs in recent years, but have not lasted long enough to cause a change in expectations.

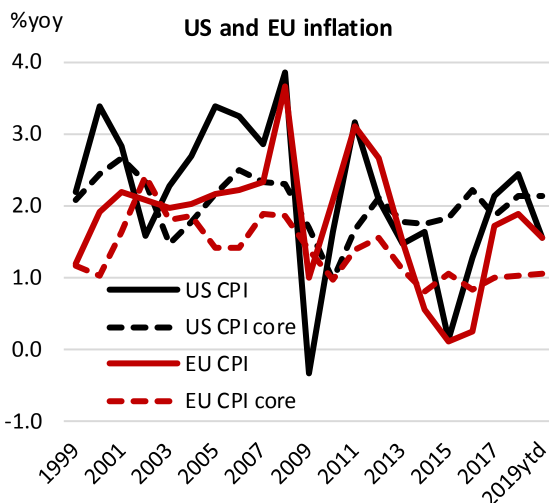
For large, advanced economies with reserve currencies, the question then becomes if persistently low inflation and lacklustre growth (due to aging and weak productivity) mean low nominal growth, with associated risks of zero bound in monetary policy, liquidity trap, rise in inequality (with return on capital outpacing the return on labour), and general economic malaise. Increasingly, the answer appears to be yes, with notions of "secular stagnation" setting in.

As these views become conventional, the policy implications turn more and more unconventional. If interest rates are likely to remain exceptionally low, and if a government can issue long duration liabilities at historically low cost, ever larger fiscal deficits and debt/GDP ratios can be entertained. If inflation expectations cannot be raised by easy monetary policy, perhaps the central banks should target higher inflation

rates, or give clear signals that even if inflation exceeds the target for a while, policy rates will not be adjusted upward.

We find it striking that only a few months ago, with the Fed hiking rates and ECB heading toward rate lift-off, it had seemed that the inflation outlook was sufficiently constructive. But now, the narrative has shifted back yet again to one of no major inflation impulse in the global economy. While financial market conditions are back to where they were in October, when the Fed was signalling many more rate hikes to come, expectation has shifted to no further hikes in this cycle, and the Fed's communication is now about dealing with downside risks to growth and inflation.

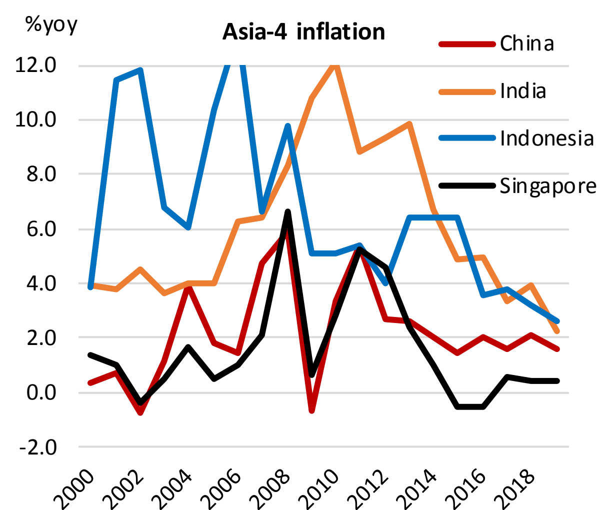
But is the picture really that dismal? How has global inflation evolved over the past decade? In the following chart, we look at US and EU inflation (headline and core) since 1999. It clearly shows that headline inflation has trended down this decade relative to the previous one, but the evidence is not that clear when it comes to core (taking food and fuel out of the index) inflation.



Source: CEIC, DBS

US core inflation fell in the aftermath of the 2008/09 global financial crisis, but has been around 2% in recent years. When one looks at the cost of healthcare, rentals, education, and a broad range of other services, there is in fact little sign that inflation has dissipated. Aging, globalisation of production, and reduced pricing power have surely pushed down the frequency and magnitude of price adjustments, but the supply-demand dynamic for many products beyond food and manufactured goods points to price rises at least in line with wage growth.

What about the key economies in our Asian backyard? Here, there has been a sharp disinflation phase for India and Indonesia, with both economies leaving their double-digit inflation track record well behind. Indeed, presently headline inflation rates in both economies are well below the inflation target of their respective central banks, hovering below 3%. Food prices have been exceptionally stable in recent years, while fluctuations in energy prices have been passed through incompletely (and with a lag). Core inflation, however, is above 5% in India, while over 3% in Indonesia, having bottomed early-last year.



Source: CEIC, DBS

China and Singapore have displayed fairly similar inflation patterns in recent decades, despite rather different price formation behaviour and inflation index weights. But periods of low inflation and sharp dis-inflation are hardly rare, looking at long-term data. Meanwhile, core inflation trend has shown no change whatsoever over the past two decades in either country, hovering around 1.5-2%.

With macroeconomic policies highly supportive in China and the US, employment conditions strong in most key economies, cost of production rising in China, and commodities showing signs of buoyancy, this is no time to give up on the chance of a cyclical pick-up in inflation, in our view. We fully appreciate the structural factors keeping prices at bay, and recognise the challenges faced by major central banks in reviving inflation expectations, but from a cyclical perspective, we would argue that the world is not standing at the precipice of serious deflationary forces.

Taimur Baig

Singapore: This year will be back-loaded

Singapore: Growth has turned out weaker than expected based on the advance GDP estimates for 1Q19. According to the advanced figures, GDP growth is projected to register 1.3% YoY, down from 1.9% previously. This is the weakest quarterly growth since Jun09, essentially the Global Financial Crisis period. However, **the economy is far from a recession**. Sequentially, growth momentum picked up to 2.0% QoQ saar, from 1.4% previously. Beside a weaker global outlook, the subpar headline growth figure is also partly due to the high base effect in the manufacturing sector, as well as the lag effect of the trade war associated with the risk-adverse behavior of manufacturers.

GDP growth by sectors

	1Q18	2Q18	3Q18	4Q18	2018	1Q19*
% YoY						
Overall GDP	4.7	4.2	2.4	1.9	3.2	1.3
Manufacturing	10.1	10.6	3.5	5.1	7.2	-1.9
Construction	-6.0	-4.2	-2.5	-2.2	-3.4	1.4
Services producing	4.4	3.0	2.7	1.8	3.0	2.1
% QoQ saar						
Overall GDP	4.7	0.0	1.4	1.4	3.2	2.0
Manufacturing	16.7	7.4	0.7	-2.7	7.2	-12.0
Construction	-2.0	-8.5	0.7	5.1	-3.4	7.8
Services producing	4.2	-2.2	2.6	2.8	3.0	4.8

* advance estimates

Indeed, **the manufacturing sector was the key drag**. Growth is expected to come in at -1.9% YoY (-12% QoQ saar). Trade tension between the US and China has led to a massive cutback in orders from China. And this came on top of an ongoing moderation in growth pace within China due to its domestic deleveraging process. However, most recent March PMI in Singapore, China and many regional peers are showing a clear sign of a rebound. This may suggest a restocking process in the making to make up for the "over-cutting" of purchases by procurement managers earlier on. **In light of this, we expect the manufacturing GDP figure to be revised up when the final set of figures are out next month**.

In line with expectation, services sector has picked up some of the slack. Yearly growth is likely to improve to 2.1% (from 1.8%), but the most encouraging sign is an acceleration in growth momentum to 4.8% QoQ saar, from 2.8% previously. While trade related services probably have been weighed down by the manufacturing sector, domestic services (i.e., IT, business services) and key financial services are expected to do the heavy-lifting. Most importantly, the services sector accounts for about 70% of the economy and employment. **Continued improvement in services will have significant implications on the performance of the overall economy, as well as employment outlook**.

The construction sector is finally out of recession. The sector registered its first positive year-on-year growth and posted a strong 7.8% QoQ (saar) expansion. Although residential construction activities remain sluggish, impetus from a healthy pipeline of infrastructure projects is gradually taking effect. **Expect better showing from this sector in the coming quarters**.

While we expect the advance figures to be revised marginally upward, we do note the lower trajectory registered in the first quarter. Considering this, **we have lowered our full year GDP growth forecast to 2.6%.**

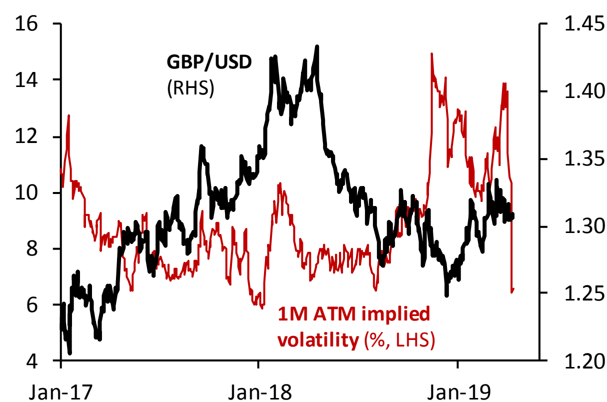
More importantly, **we believe the economy has reached the bottom of the current growth cycle**. GDP growth for the first quarter (on a YoY basis) will be the weakest. We expect a steady pick-up in growth performance in the coming quarters, as economic outlook improves. A slew of policy stimulus from China, and a stable monetary policy by global central banks will provide the uplift in global economic conditions. This should bring about a significantly stronger second half compared to the first quarter for Singapore. In short, **this year will likely be back-loaded**.

Irvin Seah

FX: Brexit fatigue & a dovish tilt from MAS

Brexit fatigue has finally arrived in a big way. The UK and the EU has agreed to a second extension in Article 50 to October 31 from April 12. Prime Minister Theresa May, however, wants the UK to exit the EU earlier on June 1 to avoid participation at the EU Parliament elections on May 23-26. To achieve this, she intends to seek compromises with her Conservative Party hardliners and the opposition Labour Party to approve a deal by May 22. The market is, however, unconvinced.

GBP succumbed to Brexit fatigue in a big way



This was evident from the meltdown in the 1-month at-the-money implied volatility for GBP/USD to 6.45 yesterday from 13.58 on April 1. Tired of cliff-edge deadlines, the market appears to appreciate the EU's decision to reject Mrs May's request for a short extension to June 30. For now, focus may shift to potential backlashes against Mrs May that culminate in leadership challenges. GBP/USD could fall lower below 1.30 as witnessed during the challenge last December.

There was a dovish tilt in the Monetary Authority of Singapore's decision to keep its SGD policy unchanged this morning. The central bank downgraded its 2019 core inflation forecast to 1-2% from 1.5-2.5% previously and expected growth to come in slightly below the mid of its official 1.5-3.5% forecast. The CPI forecast was earlier downgraded (on February 24) to 0.5-1.5% from 1-2% previously. Our model currently sees the SGD NEER in the strongest quartile of its rising policy band. This provides flexibility for the SGD NEER to ease (without changing the policy parameters) towards the weaker half of its band if the global economy fails to stabilize and falter again.

Philip Wee

Rates: Dovish undertones

This week was marked by increasing acknowledgements by policy makers that global growth remains the key challenge. The IMF downgraded its global growth forecast for 2019 to 3.3%, down from 3.5% in January. The European Central Bank (ECB) opened the door for further easing while Fed minutes suggests that FOMC members are staying flexible with rate decisions given considerable uncertainties. Suffice to say, within the developed world, appetite for further withdrawal of stimulus has waned. The ECB is tilting towards more accommodation while the Fed is more concerned about the outlook of the global economy rather than the fact that US data still appears to be holding up.

Against this backdrop, developed market govvie yields are holding near their recent lows. 10Y German yields are hovering around zero while the UST curve is flattish at around 2.4-2.5%. It is difficult to envisage a meaningful uptick in DM yields just yet. Early signs of economic stabilization in the global economy can probably be gleaned from China. The most recent manufacturing PMIs (official and Caixin) suggests that a tentative bottom may have been found after a close to five quarters slide. We probably need a couple more months of strong data before a firm conclusion can be drawn that Chinese stimuli is finally having an impact. In any case, better Chinese data did assuage growth fears, driving stock markets and Chinese govvie yields higher.

For Asia, govvie yields are heading sideways after a sizable rally over the past few months. Only India has embarked on easing, delivering two cuts. The other Asian central banks (notably Indonesia) have held back amid a relatively strong USD, a bounce in oil prices and/or may not see any urgency to cut rates just yet. In the rates space, interest rate swaps are generally pointing to further easing over the coming 1-2 years apart from China and Thailand. Lastly, the Monetary Authority of Singapore (MAS) kept its policy settings unchanged. There was a slight uptick in SGD swap rates as the statement appears somewhat dovish.

Key ideas:

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

Eugene Leow

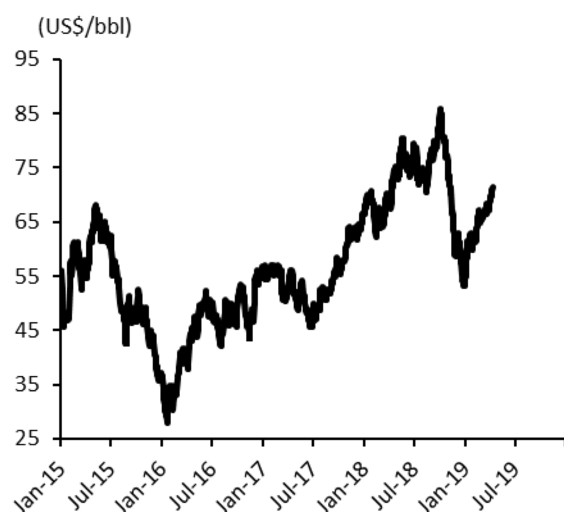
Equities: Oil price rally still has legs

DBS oil sector analysts believe that the outlook for oil price remains positive in the near term. This stems from 1) elevated supply outage risks in Libya; 2) sustained production discipline by OPEC+; 3) softer US Shale production growth and, 4) brighter demand prospects from an increasingly probable trade war resolution. **We believe oil prices will average around at the higher end of our US$65-70/bbl range forecast in 2019, implying higher oil prices in the second half of the year.**

Investors can ride on the near-term optimism on oil price through **direct exposure on the crude oil via oil ETFs, or upstream players** listed in the region. We see **more sustainable gains and greater upside potential in the oilfield service providers' space**, as global capital expenditure (capex) is poised to increase, on the back of reasonably high oil prices.

Should high oil prices sustain, the macro headwinds of rising current account deficit (rising import bills) and higher inflation will stress India and Indonesia the most, which could lead to weakened currencies, risk aversion and fund outflows. Amongst sectors, a **sharp increase in oil price is negative for airlines**, as jet fuel costs account for 25-45% of operating costs (more so for low cost carriers), though the impact on individual airlines would depend on how well and far they have hedged fuel prices. Yield-to-fare pass-on typically requires time lag depends on how much significant pricing power the airlines have.

Brent crude oil price



Source: Thomson Reuters

Joanne Goh

Highlights of the week:

China: Higher CPI will not tighten policy
HKD rates: Low aggregate balances to gently lift Hibor
South Korea & Taiwan: Tentative signs of a bottom
Chart of the Week: Singapore GDP and MAS meeting are the focus this week

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	2.6	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	6.71	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	14248	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	1.36	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	31.7	32.5	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23201	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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