Economics & Strategy Research

DBS Monthly

A Summer of Discontent

Economics/Strategy/Rates/FX/Equities/Credit

Group Research

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- ***Economics: Global market sentiments have made an abrupt turn for the worse in the past month. We see little chance of a meaningful respite any time soon. In the macro horizon, recent intensification of trade wars is threatening to undermine a nascent recovery in global trade. Positive data surprises are few and far between, while financial market volatility is on the rise.***

- ***FX: We expect the Chinese yuan to hold its ground around 6.90 into the G20 Summit on June 28-29. The British pound is ripe for revisiting its post-referendum low around 1.20 (USD/GBP)***

- ***Rates: While technicals suggest that US yields have room to head lower, we are turning increasingly wary. It would require a sizable shock to the US economy to prompt the Fed to cut rates even more aggressively than what is already priced in the market.***

- ***Equities: We believe that market volatility will remain high in the second half of the year. We are not expecting a collapse in Asian equities, but given that market valuations are high and dataflow poor, investors should stay defensive in their positioning***

A Summer of Discontent

Within a month, global market sentiments have swung from cautious optimism to near despair. After the breakdown in China-Ud trade talks, tensions have been repeatedly ratcheted up with wider sanctions and restrictions. Already, the trade war has extended into a tech war, with the US appearing adamant to prevent China'a rise as a high tech super power. Taken to the extreme, one can envisage a world where the US keeps up a permanent wall of high tariffs, and takes measures to decouple its economy away from China's. We see zero upside from this scenario; even if some countries benefit from trade diversion, the world as a whole would lose, with inevitable market inefficiencies and distortions, loss of economies of scale, slowing of investment, higher cost of doing business, and a slowdown in global product development cycles.

In the macro horizon, recent intensification of trade wars is threatening to undermine a nascent recovery in global trade. Positive data surprises are few and far between, while financial market volatility is on the rise.

Equity and credit markets reflect no rush for the exit, but global fixed income markets are sounding alarm. US rates suggest rising recessionary risks with Fed rate cuts in the horizon. European markets see no end to negative rates.

Despite risks stemming from rising tension between the US and Iran, oil prices are up only modestly. Beyond energy, the inflation picture is even more subdued, as reflected in declining breakeven inflation rates.

The risk for the US is that between potentially higher tariffs and a large public sector borrowing requirement, a period of inflation and lukewarm interest in US bonds could arise, which would cause a selloff and ensuing steepening of US curves. The danger with this scenario is that it would tilt the US toward stagflation, constraining the Fed even as investment suffers and consumer confidence takes a hit. Also, considering that global markets are not at all pricing in this scenario, the worldwide financial sector spillover could be considerable. Granted, durable goods do not make up a large component of US CPI, and hence even at 25%, tariffs won't materially change the path of inflation unless non-durable and service prices were to climb as well. But we think that even a modest pick up in inflation, if seen to be fuelled by tariffs, will cause widespread difficulties in markets and in the policy environment.

FX volatility is on the way up, particularly in emerging markets, taking cue from the slide of the Chinese RMB.

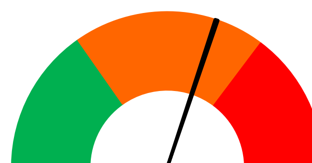
USD funding conditions are orderly, although not as comfortable as they were at the beginning of this year. Similarly, overall financial market conditions, having eased considerably in 1Q, have begun to tighten again as asset markets have turned restive.

Our key concern involves credit markets in China and the US, given the substantial debt burdens. In China, onshore credit conditions remain stable thanks to PBOC's policy easing. But a weaker RMB and a decline in total social financing and loans could cause difficulties for corporates.

US credit conditions are easy, but the debt burden is substantial. We remind our readers that seeds of financial crises usually reside in the intersection of high valuation and high debt.

We recently put together the above considerations in a global macro risk dashboard (click here). The dashboard incorporates a set of indicators to capture global macro risks. They track economic momentum, event risk, market stress, asset valuation, and supply/demand imbalance, and flag potential pitfalls ahead.The compostive signal is clear—rougher times lie ahead.

Composite Risk Score



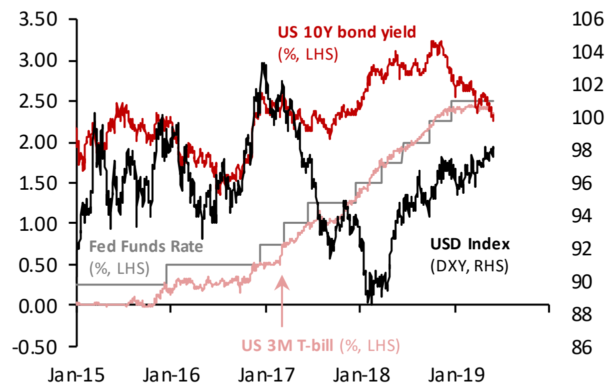
Note: The three-coloured speedometers above represent our conclusions on the outlook prevailing in various markets, as reflected in growth data, pricing, spread, and valuation metrics.

Taimur Baig

FX: USD's lingering strength

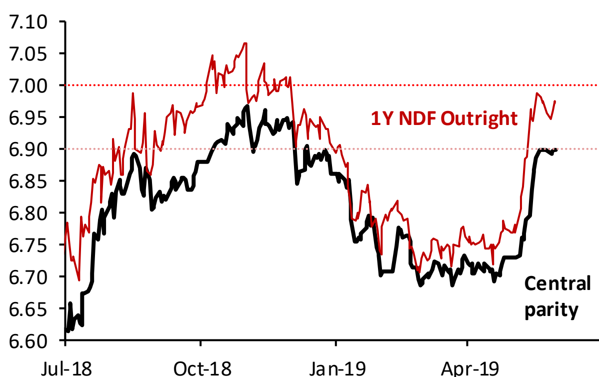
The USD has been standing its ground against lower US bond yields. The Fed will, at its FOMC meeting on June 19, acknowledge global growth risks from a re-escalation in trade tensions. The Fed, however, will not subscribe to the recession risks implied by the inverted US yield curve. To resist calls for rate cuts, the Fed has been making the case to safeguard financial stability from record high stock markets and corporate debt levels. The Fed's economic projections will probably reflect modest growth downgrades that keep rates stable for longer.

The US dollar is shaking off calls for a US rate cut



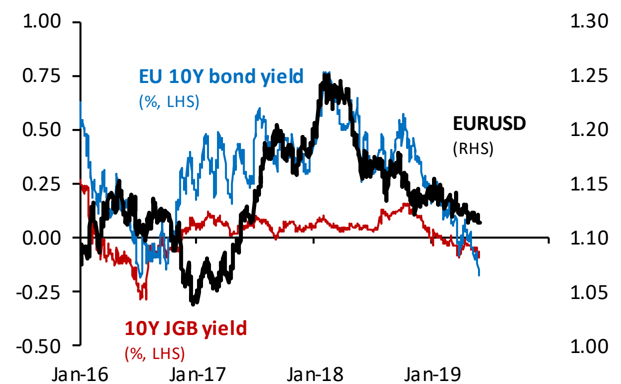
Expect the Chinese yuan to hold its ground around 6.90 into the G20 Summit on June 28-29. The central parity for USDCNY has flattened into a tight 6.8924-94 range since May 20. The 12M NDF outright did not trade above 7 like it did during the height of the tariff war last October-November. The odds have lessened for a Xi-Trump meeting to thaw the freeze in trade talks. On the other hand, China would not want to be blamed for further escalating trade tensions and stoking competitive depreciation in the region with a weaker yuan past its psychologically critical 7 level. Trump has not backed down on his threat to hit the remainder USD325bn of Chinese goods with a 25% tariff. The US Commerce Department has, on May 23, proposed tariffs on the goods of any country that the US Treasury Department identifies in the future resorting to currency undervaluation to subsidize exports.

USDCNY is not looking to rush above 7



The euro is drifting lower towards 1.10 vs the USD. The European Central Bank governing council will maintain a dovish forward guidance at its meeting on June 6. The ECB staff forecast for 2019 growth, which was last downgraded in March to 1.1% from 1.7%, will need to account for escalating trade tensions, a slowing Chinese economy, increased odds for a disorderly Brexit and a potential EU-US tariff war ahead. Not surprisingly, the euro has not been able to fend off the depreciation pressures from an increasingly negative EU bond yield that has fallen below its Japanese counterpart.

EUR weighed down by negative EU bond yield



The British pound can revisit its post-referendum low around 1.20. Theresa May will step down as Conservative Party leader on June 7 but remain as caretaker Prime Minister until a new leader is elected, probably by July 20-31. It is doubtful that the next premier can unite the party and parliament in delivering Brexit with or without a deal. Brussels has no intention to renegotiate the thrice rejected withdrawal agreement. Withdrawing Article 50 or a second referendum are no longer palatable to the Tories after the strong showing by the Brexit Party at the European Parliamentary elections. The legal default position remains for the UK to exit the EU without a deal on October 31. The Bank of England fears that corporate investment plans would be held back by another Brexit delay or abandoned on a disorderly Brexit.

Philip Wee

Rates: Trade talks gone awry

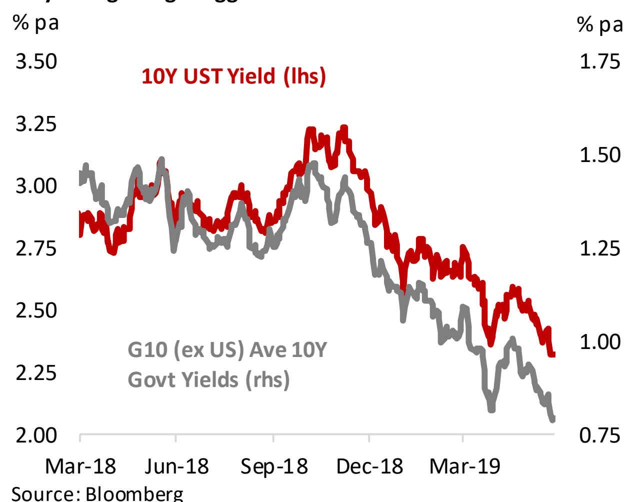
The breakdown in China-US trade talks at the start of the May led to precipitous drop in developed market govvie yields. It probably does not help that global economic data is still lacklustre amid muted inflation expectations. Against this backdrop, the average 10Y yield of G10 economies (excluding the US) fell by 34bps since the start of the year and are fast approaching levels last seen in 2016 in the aftermath of Brexit (which marked the all-time low). 10Y US yields have fallen by a similar magnitude and are hovering just above 2.30%. **The sharp rally in govvies has rendered valuation to be on the rich side**, but without positive narrative on either the trade talks or macro data, yields are likely to stay depressed for now.

USD rates are priced for a very dovish outcome (three cuts by end-2020) over the coming few quarters and appears **at odds with the relatively firm US economic data**. Note that the government bond space is the most pessimistic compared to equity markets (where are just a few percentage points off their all-time highs) and the credit space (IG and HY spreads are still relatively tight). There are two key ways that can prompt the Fed to cut rates – deterioration in financial conditions or weakness in the US economy. At this point, many of the US numbers including labour market indicators still do not show signs of easing. To be sure, inflation has come off, but under more benign conditions, it would be easy to paint the US economy to be in a sweet spot. **Unless US data suddenly weakens, the Fed might not be in a hurry to cut rates.**

By contrast, a decline in equity prices (of similar size and pace to the 4Q18 selloff) might prompt the Fed to act more urgently. Back then, fears of Fed tightening, and elevated trade tensions caused the S&P 500 to fall by 20% in three months. The Fed reacted by ending (or an extended pause) the normalisation cycle, anchoring yields lower. This time, the selloff in the stock market has been more muted (4%), but short-term US yields have been pushing new lows for the year. **This disconnect in optimism in the equity markets and pessimism in the bond market is disconcerting.**

We suspect that trade war worries and the weak global economy are probably going to keep US Treasuries rich for some time. Longer-term US yields can act as a barometer to global growth. Notably, manufacturing PMIs look weak across the US, China (the uptick earlier in the year was not sustained) and the Eurozone. Most of the G10 economies (except for Norway) are also tilting towards easing. High yields (relative to the developed) world probably render US Treasuries attractive to investors.

US yields getting dragged lower



Source: Bloomberg

While technicals suggest that US yields have room to head lower, we are turning increasingly wary. It would require a sizable shock to the US economy to prompt the Fed to cut rates even more aggressively than what is already priced in the market. Clearly, risk aversion (and a full-blown equity selloff) from further trade war escalation would probably drive longer-term US yields towards 2%. However, **the longer-term ramifications of de-optimised supply chains could well be higher inflation**. In any case, if the trade war turns protracted, market participants will have to get used to China-US friction. **Fiscal and inflation dynamics should eventually reassert.**

Eugene Leow

Equities: Position defensively in Asia markets

We believe market volatility will still be high in the second half of the year. We don't think there will be a collapse in Asia equities, and while pausing for a trade resolution which may or may not come, **investors should stay defensive in their positioning.** At this point, the downside risks are higher than the upside as **valuations are not supportive.** If a trade deal comes through, hence removing a lot of uncertainties, it is still not too late to reposition for beta, in our view.

We like markets which are domestic demand oriented, have the flexibility for policy stimulus and where valuations are attractive enough to cushion the downside. **China/Hong Kong, Singapore, Indonesia and Philippines are our favoured markets.**

Any policy or supportive responses from China in view of the challenging trade and currency conditions may lend some support to the China and Hong Kong markets. Investors should focus on sectors which are not directly impacted by the trade war, such as rail, infrastructure and cement sectors which are typically supported by government policies. We also like domestic-driven sectors such as education, property management, Hong Kong property, Hong Kong REITs, and internet.

Recall that the correction in China last year wasn't just about the trade war but also due to regulatory reform and deleveraging which had hurt many sectors and impacted credit availability. With **deleveraging partially taking a back seat** and **regulatory reform already in the price for many of the sectors**, and coupled with **supportive government measures**, we should not see a similar downward shift in sentiment like last year. As the country deals with US threats, we think there are many retaliation options, compared to last year as its domestic stimulus policies, which it has geared up, have proven to provide resilience and stability to the economy.

China 'A' shares' low correlation with global markets, due to its proportionately high pool of domestic investors, including the "National team", should also make it a fairly defensive market. Moreover, Chinese stocks will gain additional weightings in the next six months in international benchmarks, and we expect inflows to come through. Other than efforts made to stimulate the economy and stabilise growth, structural changes such as new growth transformation initiatives in Greater Bay Area, science and technology innovations, and capital market reforms should bring about more opportunities.

The Singapore market is unlikely to be spared from volatility and portends downside risks in the coming weeks. However, we think there is **enough valuation cushion to support the Singapore market**, even if US tariffs rise, provided US-China trade talks continue to take place. **Singapore REITs is still our favoured sector** as it stands to benefit from lower bond yields, which can be expected in this environment.

In Indonesia, we have to monitor the RMB for downside risks as the weak sentiment in the currency market could drive outflows in Indonesia bonds and equities, spiraling into a vicious downward cycle. **We remain positive on Indonesia as we believe its equity market should rebound** once the dust settles, **led by confidence placed in Bank Indonesia (BI)** and a rebound in the rupiah. As in last year, we see BI navigating the economy through the dark clouds. **To us, JCI at below 6000, USD/IDR at above 15,000, and 10-year bond yields at above 8.5%, if all come about, will be a strong buy for the market, as evidenced in past strong market rebounds.**

The Philippines held its general elections and a strong mandate was given to President Duterte's allies. This should ensure **policy continuity post the next presidential elections for another good six years**. During President Duterte's tenure, the country has gained rating upgrades, which is now at BBB+, and saw bitter but needed tax reforms hurting market sentiment in the past two years. **We believe with prudent macro policies going forward, growth should be sustainable in the next few years.** Pro-growth policies on infrastructure spending can be expected to continue. Inflation is still benign and that should boost sentiment and outlook for rate cuts. The central bank is cognisant on liquidity risks in the system and has started to ease the reserve requirement ratio (RRR), which is the highest in the region. We believe there is further room for RRR cuts. We stay Overweight on the Philippines.

Joanne Goh

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Growth, Inflation, Policy Rates & FX 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*	8.2	7.2	7.0	7.0	4.5	3.6	3.4	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	1.1	1.5
South Korea	3.1	2.7	2.1	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	3.00	3.00	3.00	3.00	3.00	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	1.50	1.50	1.50	1.50	1.50	1.50
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	69.2	70.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14243	14300	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.20	4.25	4.23	4.21	4.19	4.17	4.15
USD/PHP	52.6	53.0	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	1135	1170	1180	1170	1165	1160	1155	1150
USD/THB	31.7	32.0	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23189	23400	23500	23450	23400	23350	23300	23250
AUD/USD	0.71	0.68	0.64	0.66	0.68	0.70	0.72	0.74
EUR/USD	1.12	1.10	1.08	1.09	1.10	1.11	1.12	1.13
USD/JPY	111	110	112	111	110	109	108	107
GBP/USD	1.30	1.26	1.22	1.24	1.26	1.28	1.30	1.32

Australia, Eurozone and United Kingdom are direct quotes

Rates forecasts

		2019				2020			
		Q1	Q2	Q3	**Q4**	Q1	Q2	Q3	**Q4**
US	3m Libor	2.60	2.70	2.70	**2.70**	2.70	2.70	2.70	**2.70**
	2Y	2.26	2.45	2.50	**2.50**	2.50	2.50	2.50	**2.50**
	10Y	2.41	2.55	2.60	**2.65**	2.70	2.70	2.70	**2.70**
	10Y-2Y	15	10	10	**15**	20	20	20	**20**
Japan	3m Tibor	0.07	0.05	0.05	**0.05**	0.05	0.05	0.05	**0.05**
	2Y	-0.17	-0.15	-0.15	**-0.15**	-0.13	-0.10	-0.07	**-0.05**
	10Y	-0.08	0.03	0.05	**0.07**	0.10	0.13	0.15	**0.15**
	10Y-2Y	9	18	20	**22**	23	23	22	**20**
Eurozone	3m Euribor	-0.31	-0.30	-0.30	**-0.30**	-0.30	-0.30	-0.30	**-0.30**
	2Y	-0.60	-0.55	-0.55	**-0.55**	-0.55	-0.55	-0.50	**-0.50**
	10Y	-0.07	0.10	0.10	**0.10**	0.10	0.15	0.20	**0.25**
	10Y-2Y	53	65	65	**65**	65	70	70	**75**
Indonesia	3m Jibor	7.21	7.20	7.20	**7.20**	7.20	7.20	7.20	**7.20**
	2Y	6.78	6.90	6.80	**6.70**	6.70	6.70	6.70	**6.70**
	10Y	7.63	7.70	7.60	**7.50**	7.50	7.50	7.50	**7.50**
	10Y-2Y	86	80	80	**80**	80	80	80	**80**
Malaysia	3m Klibor	3.69	3.44	3.44	**3.44**	3.44	3.44	3.44	**3.44**
	3Y	3.38	3.40	3.40	**3.40**	3.40	3.40	3.40	**3.40**
	10Y	3.77	3.85	3.90	**3.95**	4.00	4.00	4.10	**4.10**
	10Y-3Y	39	45	50	**55**	60	60	70	**70**
Philippines	3m PHP ref rate	5.55	5.55	5.55	**5.55**	5.55	5.55	5.55	**5.55**
	2Y	6.78	5.75	5.75	**5.75**	5.75	5.75	5.75	**5.75**
	10Y	7.66	6.00	6.00	**6.00**	6.00	6.00	6.00	**6.00**
	10Y-2Y	88	25	25	**25**	25	25	25	**25**
Singapore	3m Sibor	1.94	1.95	1.95	**1.95**	1.95	1.95	1.95	**1.95**
	2Y	1.92	2.00	2.00	**2.00**	2.00	2.00	2.00	**2.00**
	10Y	2.07	2.15	2.18	**2.20**	2.20	2.20	2.20	**2.20**
	10Y-2Y	15	15	18	**20**	20	20	20	**20**
Thailand	3m Bibor	1.88	1.85	1.85	**1.85**	1.85	1.85	1.85	**1.85**
	2Y	1.78	1.80	1.80	**1.80**	1.80	1.80	1.80	**1.80**
	10Y	2.43	2.40	2.50	**2.60**	2.60	2.60	2.60	**2.60**
	10Y-2Y	65	60	70	**80**	80	80	80	**80**
China	1 yr Lending rate	4.35	4.35	4.35	**4.35**	4.35	4.35	4.35	**4.35**
	3Y	2.91	2.80	2.80	**2.80**	2.80	2.80	2.80	**2.80**
	10Y	3.36	3.15	3.10	**3.15**	3.20	3.25	3.25	**3.25**
	10Y-3Y	45	35	30	**35**	40	45	45	**45**
Hong Kong	3m Hibor	1.76	2.00	2.00	**2.00**	2.00	2.00	2.00	**2.00**
	2Y	1.45	1.70	1.70	**1.70**	1.70	1.70	1.70	**1.70**
	10Y	1.47	1.85	1.90	**1.95**	2.00	2.00	2.00	**2.00**
	10Y-2Y	2	15	20	**25**	30	30	30	**30**
Korea	3m CD	1.90	1.90	1.76	**1.76**	1.76	1.76	1.76	**1.76**
	3Y	1.69	1.75	1.75	**1.75**	1.75	1.75	1.75	**1.75**
	10Y	1.83	1.95	2.05	**2.05**	2.05	2.05	2.00	**2.00**
	10Y-3Y	14	20	30	**30**	30	30	25	**25**
India	3m Mibor	7.42	7.00	6.90	**6.80**	6.70	6.70	6.70	**6.70**
	2Y	6.88	6.65	6.50	**6.50**	6.50	6.50	6.50	**6.50**
	10Y	7.22	7.40	7.50	**7.50**	7.50	7.50	7.50	**7.50**
	10Y-2Y	34	75	100	**100**	100	100	100	**100**

%, eop, govt bond yield for 2Y and 10Y, spread bps

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

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