Economics & Strategy Weekly

Weekly: Litany of Risks

DBS Group Research

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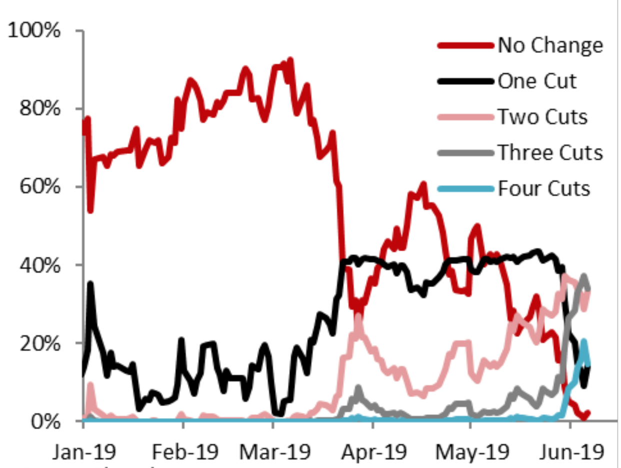
- *Global market conditions are ripe for heightened volatility. From inflation to trade, the outlook has been lurching around tweets from the White House.*
- *2019 Fed rate cuts are now fully priced in; we however wonder if that would help the markets*
- *FX: China has lately signalled a preference for currency stability; we think this is temporary.*
- *Rates: Asia rates/govvies should benefit as lower-for-longer becomes the theme*
- *Equities: We are maintaining Thailand as neutral despite trade war-related headwinds*

Does a Fed rate cut matter in the current environment?

The list of downside risks to the global economy has lengthened considerably since the beginning of May. They include a sharp escalation in China-US trade wars, a considerable ratcheting up of US pressure on China's technological capabilities and potential, rising tension around Iran, US spat with Mexico on immigration, and the US broadening trade tensions vis-à-vis India and Europe, along with currency manipulation charges against some key economies. European consumption and business sentiments have been weakening, whereas the rapid spread of Swine fever is wreaking havoc with meat production in China.

Due to this litany of risks, general or idiosyncratic, our assessment of the global economic outlook has worsened considerably. A nascent recovery in trade and business sentiment has been undermined severely by an escalation and broadening of trade wars, progressively weak data prints, as well as a rise in geopolitical tension. The markets' focus, in this context, is on the Fed. Should the US ease monetary policy, perhaps some of headwinds building up can be assuaged, and the long global expansion cycle can be prolonged, goes the thinking. In recent weeks, expectations of Fed policy easing have spiked sharply, as seen in the following chart.

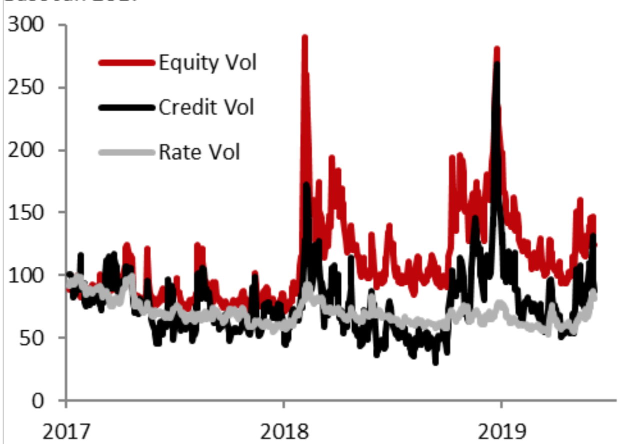
Futures-implied probability of Fed action by end-2019



Source: Bloomberg

Granted, despite the recent selloff, market volatility has risen only modestly. Monetary conditions are not particularly challenging, there have been no major events to suggest liquidity support is warranted, and policy makers in key economies are already sounding very dovish. Hence there is no immediate case for a rate cut, especially in the US, where the labour market is tight and wage growth strong, notwithstanding the dovish tone coming from senior Fed officials.

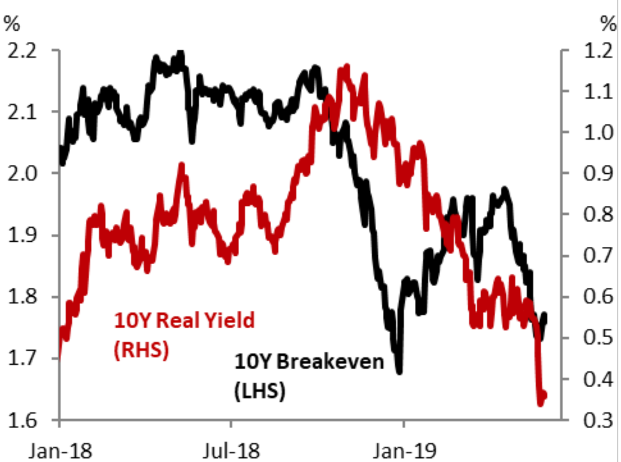
Implied Volatilities across Asset Classes



Source: Bloomberg

The fixed income market is pricing in a series of rate cuts nonetheless, predicated on the potential for lasting damage to the global economy from prevailing uncertainties, as well as the view that the real policy rate is too high at a time of ballooning downside risks and chronically below-target inflation.

10Y US Real Yield vs Inflation Compensation



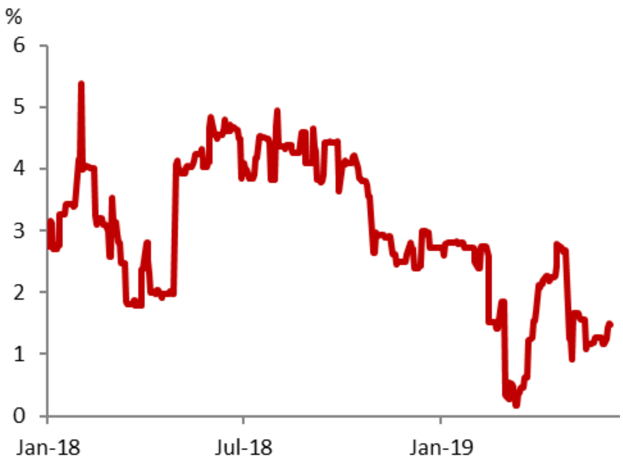
Source: Bloomberg

From the US Federal Reserve's perspective, it will become progressively difficult to ignore the market dynamics and pipeline economic risks, in our view. We are therefore now calling for 25bps rate cuts in September and December of this year.

The outlook for 2020 is exceptionally cloudy, as some sort of a resolution in China-US tensions could boost sentiments on one hand, whereas rising pass-through from higher tariffs could create a stagflation-type scenario on the other hand, constraining Fed policy. Considering this, we are leaving our call for no further changes in policy rates in 2020 unchanged.

Will the rate cuts accomplish much? We doubt it; the risks to economic slowdown is not coming from high cost of capital. Moreover, there is no link between tariffs and monetary policy. Furthermore, given the considerable rise in public and corporate debt burden over the past decade in the US, a tad lower interest rate payment won't act as a catalyst to pile on more leverage, in our view.

US GDP Forecast (Atlanta Fed)



Source: Bloomberg

The Fed's motivation to cut rates would stem from the need to be seen doing something, and the notion that lowering real rates would help soothe the credit channel at a time if heightened risk aversion. That the policy rate cut could come in less than three months from now also implies that Fed policy would not be pursued in response to data releases, which may well remain broadly fine for the US in the near term. A hint or two on growing inventories, further unrest in global financial markets, and a worsening of inflation expectations would be sufficient, in our view.

Taimur Baig

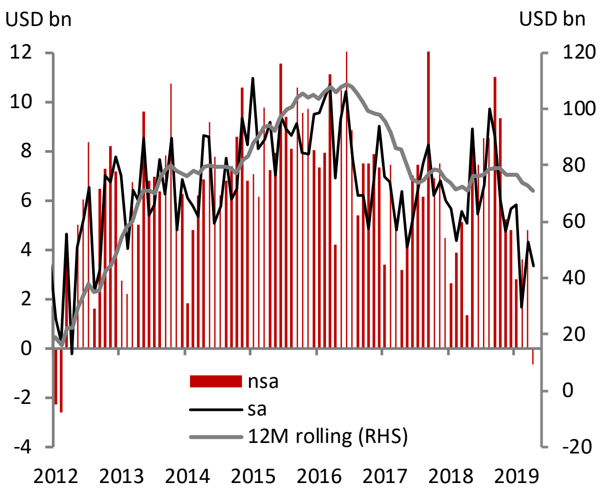
South Korea: Revising down current account forecast

South Korea's current account posted -USD 665mn in April, the first monthly deficit seen over seven years. We believe that **April's deficit was a temporary phenomenon, largely attributed to seasonal factors**.

Data breakdown shows that the income account fell into a large deficit of -USD 4.3bn in April. This reflected rising dividend payments by Korean companies to foreign shareholders during the earnings season. On a seasonally adjusted basis, the current account remained in a solid surplus worth USD 3.4bn in April.

On a 12-month rolling basis, the cumulative surplus in the current account has remained strong at USD 70.9bn as of April, equivalent to 4.2% of the country's annual GDP. It was no surprise that the US Treasury has kept South Korea on its monitoring list for unfair currency practices during the latest assessment in May.

South Korea: Current account balance



We expect the current account to return to the surplus position from May onwards, but the size to shrink on a YoY basis. **For the full year of 2019, we are revising the C/A forecast to USD 62bn (3.7% of GDP), down from the previous estimate of USD 73bn (4.6% of GDP).**

Exports outlook is currently weighed down by the escalation of China-US trade war. Nearly 40% of South Korea's exports head to the China and US markets. Electronics and automobile products, which are relatively price/income elastic, account for nearly 40% of South Korea's total exports. A demand decline in China and the US, as a result of trade war, could have considerable spillover impact on South Korea. The latest trade figures showed that South Korea's exports deteriorated again in May after a short-lived improvement in April. The YoY contraction in exports widened to -9.4% in May, the biggest over 34 months (excluding the Lunar New Year). Dragged by the decline in new export orders, manufacturing PMI also dipped to 48.4 in May after a temporary rebound to 50.2 in April.

Imports are expected to remain relatively stable on the other hand. About 20% of South Korea's imports are comprised of petroleum-related products. The US's waiver on Iran sanctions has recently expired in May, which obliged Iran's major oil buyers including South Korea to look for alternative sources of supply and bear higher costs. Lower production estimates from Iran and geopolitical factors could keep global oil prices elevated in the rest of this year, despite the demand concerns stemming from trade war.

Admittedly, the recent depreciation of the KRW should help to boost inbound tourism and curb overseas travel of domestic tourists. That said, the correlation between the USD/KRW and the size of travel account deficit has been insignificant in the last several years (0.25 in 2014-18, vs -0.50 in 2008-13). It is doubtful to what extent the services account will improve and whether it will be enough to offset the deterioration in the goods account.

Implications for the KRW

The one-off current account deficit in April, together with the negative external events in May (escalation of China-US trade war, resumption of missile tests by North Korea) should help to explain the 4.9% deprecation in the KRW versus the USD during the past couple of months.

Going forward, **barring new external shocks, the volatility of the KRW should ease somewhat compared to the Apr-May period.** That said, the overall BOP position will likely remain weak and continue to weigh on the KRW in the rest of this year, given the narrowing of C/A surplus, deterioration in growth prospects and rise in BOK rate cut probabilities. DBS strategist expects the USD/KRW to consolidate in the 1170-1180 range in 2H19.

Ma Tieying

FX: Balanced by broadening rate cut expectations

In the Developed Markets, the Japanese yen remains be favoured as a hedge against risk aversion. Fed cut expectations have provided some respite to the euro in the short-term. The single currency is still weak over the medium-term as evidenced by its record low EU 10 bond yield below its Japanese counterpart. The Australian dollar is expected to stay weak below on expectations for more rate cuts by the Reserve Bank of Australia. The British pound is weak from increased prospects of a no-deal Brexit on October 31 especially if hardline Brexiters such as Boris Johnson succeeds Theresa May as the British prime minister in late July.

Momentum Dashboard of currencies as of June 6

Mov ave	50-day	100-day	200-day
JPY	2.1%	2.1%	2.8%
EUR	0.3%	-0.3%	-1.1%
AUD	-0.7%	-1.4%	-2.0%
GBP	-1.7%	-2.3%	-1.9%
THB	1.5%	1.1%	2.7%
INR	0.4%	1.1%	2.4%
PHP	0.7%	0.9%	1.9%
IDR	-0.1%	-0.6%	1.4%
HKD	0.1%	0.1%	0.0%
SGD	-0.1%	-0.4%	0.0%
VND	-0.5%	-0.7%	-0.6%
MYR	-0.9%	-1.5%	-0.9%
TWD	-0.9%	-1.3%	-1.5%
CNY	-1.7%	-2.1%	-1.2%
KRW	-1.5%	-3.1%	-3.9%

In Emerging Asia, the export-led Northeast Asian currencies – South Korean won, Chinese yuan and Taiwan dollar – have been most vulnerable to a further escalation in global trade tensions. However, over the past fortnight, China has signaled a preference for currency stability by keeping the USDCNY central parity on a tight leash around 6.89. China's stock market has returned more than 50% of this year's gains amidst a return in its manufacturing PMI below 50 again. This temporary stability before the G20 Summit on June 28-29 has returned some interest into the Thai baht, Indian rupee and the Philippine peso, and to a lesser extent, the Indonesian rupiah. Indonesia is awaiting the opportunity to join India and the Philippines in easing monetary policy to cushion growth from global headwinds.

Philip Wee

Rates: Shallow Fed cut cycle ahead

We have revised our USD, SGD and HKD rates forecasts lower, reflecting two Fed cuts by the end of 2019. If the Fed delivers, this would be one of the fastest about turn in history (keeping in mind that the Fed last hiked in December) as global growth worries and the prospect of protracted China-US friction weigh. The USD interest rates space has clearly been ahead of the curve over the past three quarters. 10Y yields peaked at 3.24% in November, recognizing that further hikes were probably not warranted. More recently, the curve bull-steepened (2Y/10Y) as market participants aggressively start to factor in Fed cuts. Almost four cuts are priced into the Fed funds market within a year, reflecting expectations of slowing growth and heightened uncertainties on the US's trade policies.

While we recognize that global growth worries are dominant, we should keep in mind that the yield declines have been sharp. As 10Y US yields hover just above 2% and 10Y German yields start to get sticky at -0.2%, we think it might be time to be more cautious about duration risks. We think that 2-2.5% would be where 10Y US yields would be trading for the coming quarters. Yields could head into the 1.5-2.0% range if the global economic outlook deteriorates further but we reckon that valuations would be too stretched. In 2016 and 2013, a rapid re-repricing of inflation expectations led to a Treasuries' selloff.

Asia rates / govvies should benefit in the medium term. As lower for longer becomes the theme in the developed market space, investors will look to Asia for yield. By some metrics, Asia govvies are attractive, offering high real yields. Policy settings are also tilted towards easing. India, Malaysia and the Philippines have already started cutting rates. We think it could be a matter of time before other economies join in. In the immediate term, risk appetite is critical to watch. Fed cut cycles are typically taken during times of risk aversion. This could lead to period of underperformance in Asia govvies before yields head meaningfully lower.

Eugene Leow

Equities: Thai market's recovery post elections

Following a clearer political picture with **the appointment of General Prayuth Chan-o-cha as the Prime Minister**, **we believe a major overhang on the Thai market is removed**. Looking forward, the market will be focusing on the list of new cabinet members and potential **stimulus measures to boost the economy in the second half of the year**. Note that the Thai economy has a weak start to the year, expanding by 2.8% in 1Q19, vs +3.6% in 4Q18, and is the slowest pace in four years. Accordingly, the National Economic and Social Development Board (NESDB) cut 2019F GDP growth forecast to 3.3-3.8%, down from 3.5-4.5% forecasted earlier in Feb 2019.

The slowdown in GDP in 1Q19 was due mainly to weak exports (-3.6% y-o-y) amid deteriorating global trade and the slight drop in public investment (-0.1%) ahead of the election. Note that exports contributed about 74% of Thailand's GDP in 1Q19. Further on in April, Thailand's exports growth decelerated to 1.9% %YoY, with most product categories and exports to most markets showing negative y-o-y growth. This was due to the slowdown in global trade and demand from trading partners, including the EU and China.

We expect ties with foreign governments, especially the Western ones like the EU, to resume following the general election. Trade talks and investment flows should then follow. Thailand bonds and equities have not been able to receive their fair share of flows since the coup in 2014. We believe Thai government bonds are attractive from a US-Thai yield spread perspective, and that unlike other Asia central banks, BoT has yet to show any dovishness in its monetary policy. Its currency should also be one of the more resilient ones in Asia as it maintains a strong current surplus despite some weakness seen in its exports.

Relationship with China will continue to flourish as policy continuity can be assured post elections, although a weak coalition government could result in a lengthy approval process for investment projects. Relationships with ASEAN countries will continue to strengthen as Thailand assumes the ASEAN chair this year, with increased economic co-operation expected with the CLMV (Cambodia, Laos, Myanmar and Vietnam) markets. Thai corporates have been able to tap the opportunities available in the CLMV countries and are front runners in investments in these countries.

We are maintaining Thailand as Neutral despite the headwinds from global trade tensions. We recommend investors to accumulate stocks with solid fundamentals, reasonable valuation and decent yields. **We still like the Commerce and Finance sectors, which should benefit from a domestic consumption recovery.** We are upgrading the Industrial Property sector to Overweight, as it should be a prime beneficiary of US-China trade tensions.

We are still positive about the commerce sector with **the CCI (Consumer Confidence Index) number remaining high in recent months**. In addition, the government has **launched several tax-saving schemes for shopping and tourism campaigns which will help boost domestic consumption.** Domestic demand-led growth should propel SSSG (same store sales growth) into positive territory while retailers are expected to continue accelerating their store expansion. In the meantime, the positive SSSG would enable operating leverage with company-specific factors as the key drivers. Also, most of the companies are pursuing efforts to widen their margins to sustain their profitability over the long term from a shift towards high-margin products and increasing sales of house brands.

Finance companies in Thailand currently have an average effective yield of 23-25% p.a. They have been able to make use of the opportunities brought about by BoT lending rule changes to acquire new customers, review credit limits, and being proactive with promotional campaigns that will help stimulate existing customer spending. We expect these companies to continue to deliver decent earnings growth.

We believe the industrial property sector has bottomed out and is now in an early stage of an upcycle. The sector should benefit from US-China trade tensions, EEC (Eastern Economic Corridor) progress, and the establishment of the new government. The industry is now seeing rising demand from those companies that want to relocate their production bases out of China to avoid the US import tariffs.

Joanne Goh

Highlights of the week:

Understanding China-US Relationship: Self-interest vs Mutuality
FOMC to cut rates as insurance
India: 3 reasons to be bullish govvies
SGD rates: Time to grab yield
Position Defensively
Singapore Chartbook: Down but not out

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018	2019f	2020f	2017	2018	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	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	2.1	2.5	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	1.7	1.6

* 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	4.50	4.25	4.25	4.25	4.25	4.25	4.25
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	2.25	2.00	2.00	2.00	2.00	2.00

* 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

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