Economics & Strategy Weekly

Weekly: Currency War and Monetary Easing

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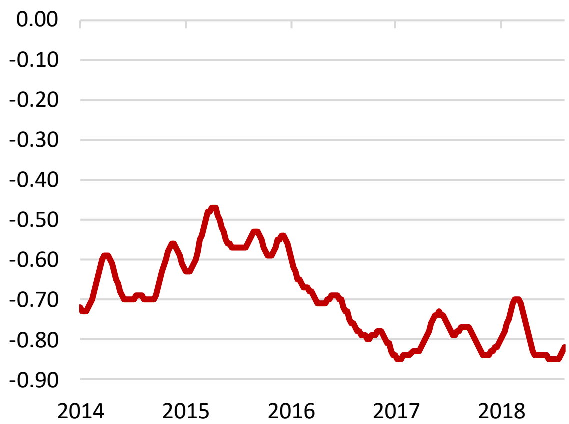
- *All major economies of the world appear to be pursuing a weak currency policy.*
- *As inflation disappoints on the downside, a weaker currency should reduce deflation risks, but only in theory.*
- *Strong doses of zero rates and quantitative easing have not managed to create sustained inflation in Japan, EU, or the US, although the exchange rates have moved about considerably.*
- *In the absence of supply-demand imbalance, and in the presence of declining potential growth and gains from technological advancement, a bout of currency weakness is unlikely to turn inflation around.*
- *The notion that growth can be boosted through competitive devaluation is outdated, in our view.*

Will a dovish Fed generate a weaker dollar?

Without actually cutting interest rates, the US Federal Reserve has generated major easing of financial conditions this year. While this week's FOMC statement and accompanying forecasts suggest continued shift toward easing monetary policy in the coming months, we remain unsure if so much dovishness Is justified. The dovish shift may be sufficient to please the markets, but it should be clear that the shift in stance was not seismic. The US central bank officials have demonstrated eagerness to ease financial market conditions from the beginning of this year. Judging by the National Financial Conditions Index calculated by the Chicago Fed, they have achieved that already (although it is also clear that conditions were not particularly tight even during the stock market selloff in December).

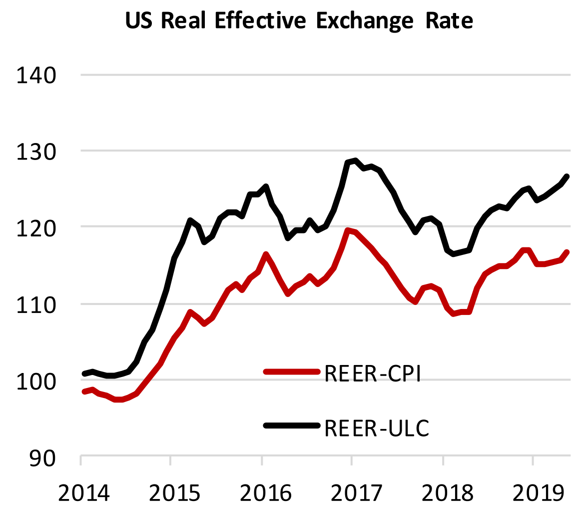
National Financial Conditions Index



Source: Chicago Federal Reserve, DBS

The objective of the White House however is clear; it wants the Fed to cut rates to support growth through a weaker dollar. While criticising other economies for currency manipulation, by calling for Fed policy easing repeatedly, President Trump has put the US at the centre of currency wars.

The motivation for this may come from the fact that US real effective exchange rate has appreciated steadily in recent years. Whether measured by using the consumer price (CPI) index or unit labour costs (ULC), the dollar has appreciated, in real terms, by 15-25% over the last five years, as per IMF data.



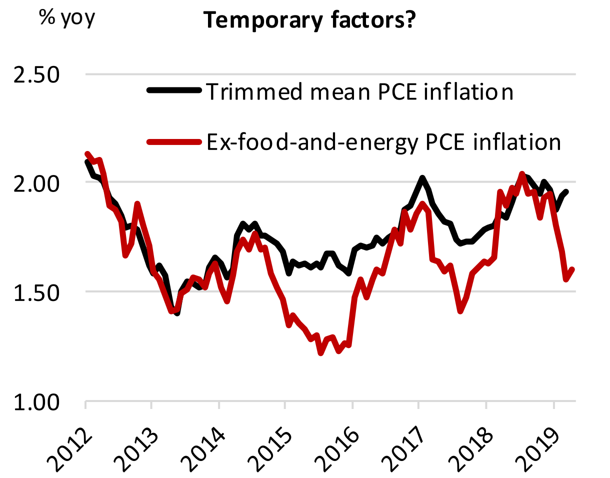
Source: IMF, DBS. REER set at 100 for Jan-Dec 2010

But shouldn't the exchange rate have appreciated against major partners given the US economy's strong growth outturn in recent years? Indeed, looking at growth, investment, and financial conditions index, it doesn't appear the gradual appreciation of the dollar has had a negative impact on the US.

Furthermore, with trillions of dollars of European and Japanese debt yielding negative interest rates, growing amount of USD-denominated debt issued by both developed and developing economies, demand for USD is unlikely to wane anytime soon, regardless of the Fed's stance, in our view.

Additionally, there could be a notion that a weaker USD should reduce deflation risk, but this is valid only in theory. Dollar's fluctuation has had little impact on inflation or inflation expectations in recent years, with disinflation being driven far more by the lack of market power among producers and technology-led cost savings.

Moreover, the highly defensive rhetoric on inflation being well below the Fed's target needs to be seen in context. Analysis done by the Dallas Federal Reserve shows that core inflation has been on an uptrend since 2013, interspersed with temporary downshifts. In fact, a comparison of trimmed mean and core Personal Consumer Expenditure (which excludes food and energy) inflation shows that core PCE tends to deviate far more than the underlying rate of inflation. We are sure that Fed officials will keep this in mind as they consider forthcoming data. This means that although the next cut is likely to be defended as an insurance against below-target inflation, that evidence is nowhere close to being compelling to support such a move.



Source: Federal Reserve Bank of Dallas, DBS

If inflation is not particularly low and exchange rate depreciation is not a major source of competitive gains or adequate insurance against disinflation, the desire to see a weaker dollar seems old fashioned and unlikely to provide much dividend, in our view. But implicit in monetary easing by the BoJ and ECB in recent decades has also been a desire to guide respective currencies weaker. Now with the US joining the fray, the markets will be pulled between major central banks of the world, all pursuing dovish policies. The net impact may well be status quo, unless there is major relative change in real interest rates in the US vis-à-vis Europe or Japan. Since this would require an unlikely mix of easing by the US with no commensurate easing by its partners, we don't see a major dollar easing cycle ahead.

Finally, In the absence of supply-demand imbalance, and in the presence of declining potential growth and gains from technological advancement in advanced economies, a bout of currency weakness is unlikely to turn inflation around. The notion that growth can be boosted through competitive devaluation is therefore outdated, in our view.

Taimur Baig

FX: A relief rally ahead of the G20 Summit

This week's appreciation in the Developed Market and Asian currencies is considered a relief rally. The scheduled Xi-Trump meeting at the G20 Summit on June 28-29 has alleviated fears of a further escalation of trade tensions between the world's two largest economies. The stronger CFETS mid-rate for the Chinese yuan from 6.89 to 6.84 vs the USD was viewed as an encouraging gesture from China. US stock markets are near their lifetime highs on the dovish tone in the Fed. Ironically, central banks have taken their cues from plunging bond yields not to take any chances in a quick resolution.

Washington wants to maintain existing tariffs to ensure China's compliance to address America's concerns on its trade deficit, intellectual property and other issues. This point was reinforced by Trump's decision to increase, on May 10, the tariffs on USD200bn of Chinese imports to 25% from 10%. And Trump has not rescinded his threat to hit a 25% levy on the remainder USD325bn of Chinese goods. Understandably, the Fed and the European Central Bank have responded by opening the door to provide monetary policy support. **The USD Index (DXY) may find support at 96.5**. Record high US stock indices are not consistent with a US 10Y bond yield below the Fed's 2% inflation target.

Unlike the previous Tory leadership challenge last December, the British pound may not rebound from its 1.25 low. Apart from global risks, hard Brexit worries have found its way into the Bank of England who downgraded UK's 2Q19 growth to 0% from its earlier 0.2% forecast in May. Tory MPs have, after five ballots, voted leading Brexiteer Boris Johnson and foreign secretary Jeremy Hunt as the two candidates to succeed Theresa May as prime minister. Both now need to win over the 160,000 Conservative Party members in a run-off from June 22 to July 21. The new leader will be announced in the July 22-26 week and take up residence at No. 10. After the strong showing by the Brexit Party at the European Parliament elections, the Conservatives believed that the party's survival is contingent on delivering Brexit, with or without a deal, on October 31. Hence**, the risk for the pound to revisit its post-Brexit referendum near 1.20 cannot be discounted**.

Philip Wee

Rates: The big DM govvie rally

By many measures, the rally in developed market govvies looks stretched. 10Y UST yields are already more than 120bps down its peak last year and is hovering below 2%. Similarly, 10Y German yields pushed to a fresh low (below -0.3%), reinforcing the fact that zero is not the floor for rates. Much of this is due to dovish guidance from the Fed and the European Central Bank ECB and the outsized reactions in the interest rates space. When the Fed indicated flexibility in lowering rates on account of heightened uncertainties, short-end USD rates took the chance to push even lower, factoring in 100bps of cuts within a year. The market has a base case cut in July, but we think that may be contingent on poor US data and or worsening trade war narrative post G20.

The ECB's was more dovish than anticipated. With the deposit rate already at -0.4% and a scarcity of selected government papers (notably Germany) from previous rounds of asset purchases, we thought that the ECB might be more reticent. Such concerns appear unfounded as Draghi signalled that rate cuts and QE are on the cards, driving the rates space to factor in 13bps of cuts by the end of the year. If QE is announced, we suspect that it would be the peripheral govvies that benefit the most as the ECB would probably have to loosen the criteria and reduce weightage on economies that have limited outstanding papers.

Meanwhile, the Bank of Japan BOJ appears to be the least dovish of the G3 central banks. That said, Kuroda did indicate that the yield curve band (±20bps) should be interpreted more loosely. With the 10Y yield target at zero, the theoretical floor is -0.2%. This suggests that the BOJ may not enforce the floor and allow 10Y yields (-0.18%) to drift even lower. Room to hold off easing may be constrained if the yen becomes too strong and perhaps explains why JPY interest rates have drifted lower despite a more "neutral" BOJ.

Eugene Leow

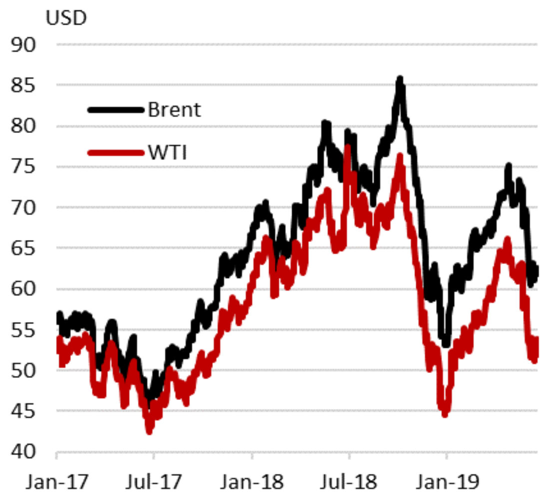
ETF equities: Rising Middle East tension to take oil and gold prices higher

As the US-Iran tension escalates, opportunities have arisen for gold and oil trades, which are **accessible through ETFs.**

Gold prices have since recovered from their lows and we think the recovery could be sustainable. **Rising political tension, lower bond yields and USD on the verge of reversing should make the rest of 2019 very interesting for the gold market**. Gold prices have formed a wedge or pennant pattern that has been in place for several years. The positive aspect of this pattern is its trend of higher lows. Fundamentally, gold has been resilient, gaining strength from escalating geopolitical risks and uncertainties. Whether the aforementioned catalysts are strong enough to take gold prices to a new higher trend line remains to be seen.

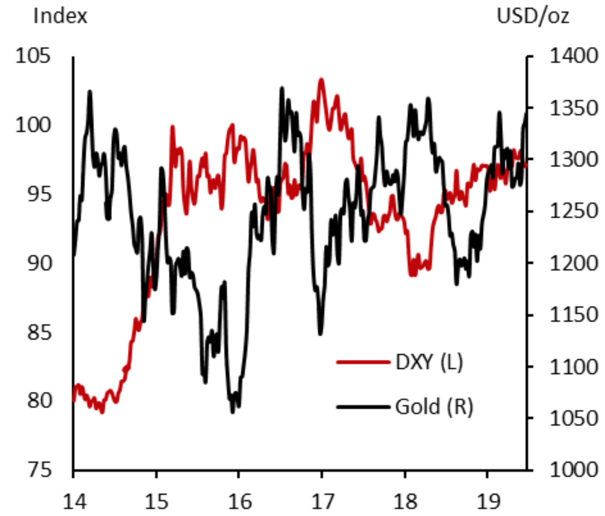
Oil prices have been volatile in the past one year as the tussle between supply and demand keeps prices in a wild range. **With oil prices having fallen near to the year's low recently due to a re-escalation in the US-China trade war, we think the upside risk is there with the rising tension in the Middle East.** DBS regional oil & gas team believes that the supply risks are being underestimated at this point, as the supply side was already affected by stricter Iran sanctions, declines in Venezuela, outages in Libya while demand concerns took centre stage. We thus expect oil prices to gradually recover from current levels with the rising Iran tension as an immediate catalyst.

Oil price recovering from low



Source: Thomson Reuters

Gold price and USD holds inverse correlation



Source: Thomson Reuters, DBS

Higher lows for the Gold price

Source: Thomson Reuters, DBS

Joanne Goh

Highlights of the week:

Fed poised to cut, but only with much more soft data
India's monetary policy to do much of the heavy lifting
Taiwan chart book – Trade war's costs and silver lining

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	6.8	6.8	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	5.50	5.25	5.25	5.25	5.25	5.25
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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