Weekly: ECB's dovish leadership transition

Economics/Strategy/Rates/FX/Equities

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- *A changing of the guard is underway at the European Central Bank*
- *Nominated to be President is IMF MD Christine Lagarde; she will start on November the 1st.*
- *New Chief Economist Philip Lane took over last month*
- *The Lagarde-Lane team will not deviate much from the strong and dovish path pursued by ECB under Draghi*
- *In the near term, further action will warrant a demand shock, which is not in the central scenario, but an exacerbation in the global outlook will very likely cause ECB to ease*
- *In the medium term, we would expect some of Mr. Draghi's past exhortations about stronger European institutions to be amplified by Ms. Lagarde*

A changing of the guard is underway at the European Central Bank (ECB). Chief Economist Philip Lane took over from Peter Praet last month, and earlier this week the European Council nominated the Managing Director of the International Monetary Fund, Christine Lagarde, to succeed Mario Draghi as President of ECB (on the 1st of November). Both appointments are praise-worthy, with these two veterans of central banking (Lane) and political economy (Lagarde) likely to provide strong leadership to Europe's central bank.

Their work won't be simple, despite sizeable achievements of ECB under Mario Draghi. The Draghi-led ECB provided considerable support to European banks during the 2011/12 debt crisis, strengthened confidence in the Euro with the famous "whatever it takes" comment in mid-2012, and embarked on a major asset purchase programme in 2015 that added 20% GDP to its balance sheet in 4 years. Consequently, the eurozone has experienced a gradual recovery, deflation threats have been largely eliminated, borrowing has picked up thanks to record low lending rates.

But lately, the momentum of growth and credit growth has slowed, inflation has been well-below target, and long-term rates have fallen below zero, suggesting fears of protracted stagnation. The Lagarde-Lane team will have to deal with these considerations.

Note that despite these concerns, financial conditions are not tight, banks are not under stress, liquidity is ample, and recession risks are not considered imminent. The need to take urgent and outsized measures has yet to arise, in our view.

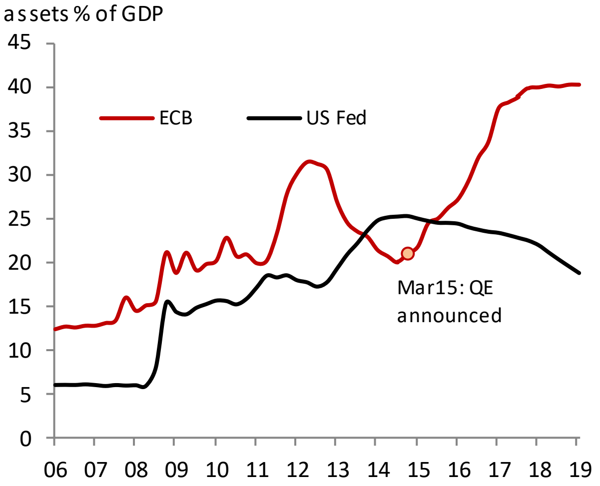
This is why the mid-June speech by Mr. Draghi raised many eyebrows, as in the process of trying to assure the markets that the central bank has the tools to prevent deterioration of inflation expectations, he sounded ultra-dovish. He lowered the bar for further policy action, either through more negative interest rates or additional asset purchase, to the absence of improvement in economic conditions (as opposed to further deterioration). This was seen as his attempt to tie the hands of his successor from any possible scaling back of supportive measures before 2021.

With the Lagarde-Lane team, Mr. Draghi need not worry. As the Governor of the Central Bank of Ireland, Mr. Lane has demonstrated a level-headed and pragmatic approach to policy making, balancing growth imperative with financial stability. As former Finance Minister of France, and IMF MD, Ms. Lagarde is comfortable dealing with political mine fields; she is adept at building consensus, but not shy from telling hard truths.

Will the ECB veer toward more and more unconventional policy in the coming years? We won't bet on it, as the new leadership may well underscore the importance and primacy of coordinated fiscal and structural policy to move the economy forward. We don't think the new leadership will have to do anything major to establish their credentials, their credibility is not under question in any case. Of course, if stagnation foments and the Eurozone faces renewed threats to stability, the ECB will act, but we don't think the bar needs to be as low as what Mr. Draghi has set.

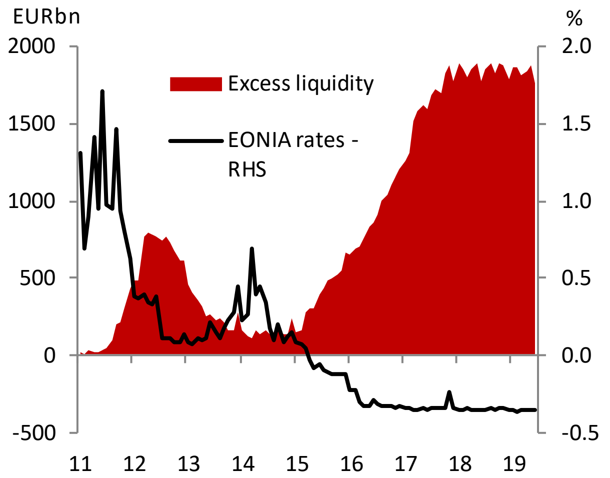
We would expect some of Mr. Draghi's past exhortations to be amplified by Ms. Lagarde. The need for additional and stronger pan-European institutions to solidify policy coordination and form a genuine monetary union, as well as more flexibility in structural (labour market, in particular) and economic policy making will be called for by Ms. Lagarde, in our view.

US Fed vs ECB Balance sheet



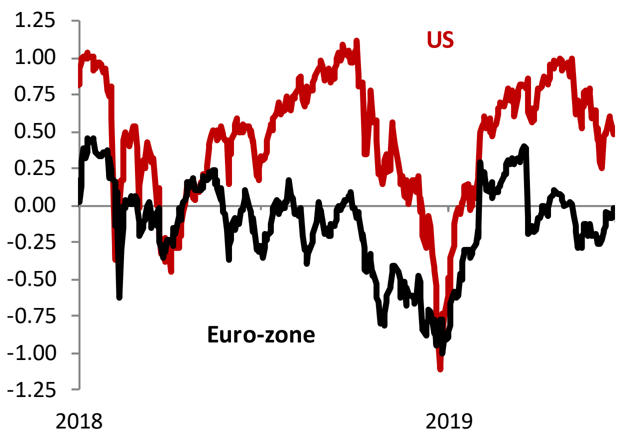
Source: Bloomberg, DBS

Excess reserves in the system



What should the markets take away? Short of additional demand shocks, the rates curves may well prove to be too rich, in our view. If China-US strife intensifies and global growth weakens considerably next year, the ECB will have to act, but we doubt if that is the central scenario of Lagarde-Lane. Given the spate of downward revision to growth and inflation forecasts already, the risk to the outlook is balanced in our view. As seen in the recent statement of the G20 leaders, the central scenario is in fact one of growth bottoming out in the second half of 2019. As for the euro, it is hard to build a bullish case, unless there is a major improvement to the outlook. Despite US President Trump's frustration with a weak Euro, we don't expect ECB to undertake any policy that would remove the market's dovish view on the currency.

Financial Conditions Indices



Source: Bloomberg

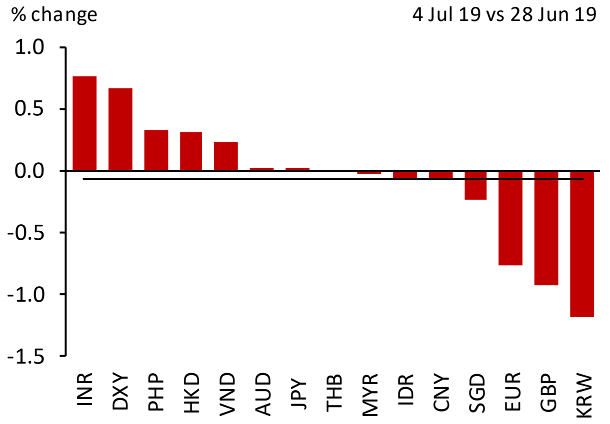
Note: A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

Taimur Baig

FX: The dovishness of the Fed pales against those from the BOE and ECB

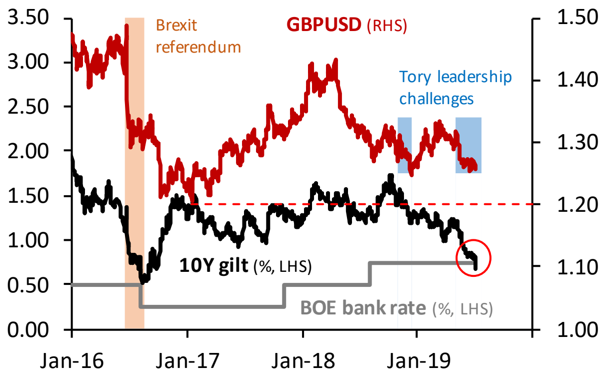
The US dollar index (DXY) has bounced off its support at 96 despite strong bets for a Fed cut this month. The risk of disappointment at the FOMC meeting on July 31 cannot be dismissed. Trade war fears have subsided after China and the US agreed, at the G20 Summit on June 29, to suspend tariffs to resume trade negotiations. Benchmark US stock indices have subsequently rallied to new record highs and provided the Fed a reason to keep the powder dry.

Performance of currencies in July 2019



Cleveland Fed President Loretta Mester, who is not a voting member, prefers waiting for data to gauge the resilience of the US economy to global headwinds. Even St Louis Fed President James Bullard, the most dovish member who voted for an insurance cut on June 19, was uncomfortable with how aggressively markets pushed for a Fed cut cycle. Fed Chairman Jerome Powell's semi-annual testimony to US lawmakers on July 10-11 will establish how patient the Fed will be in easing rates.

GBP to revisit post-referendum low on hard Brexit risk



Sources: DBS Research, Bloomberg data

The British pound is at risk of revisiting its post-2016 Brexit referendum low around 1.20 against the USD. The Bank of England has acknowledged the risk of a hard Brexit and opened the door for rate cuts. Boris Johnson, who is the frontrunner in the Tory leadership contest to succeed Theresa May as prime minister later this month, has pledged to take, with or without a deal, the UK out of the EU on October 31. Unlike the post-referendum rate cut in August 2016, the 10Y gilt yield did not hold above but fell below the BOE policy rate today. More importantly, there will be no transition period if UK crashes out on Brexit Day. Not good given the negative GDP growth expected for 2Q19; data release is scheduled for August 9.

The euro's attempt to reverse its downtrend in June has lost traction this month. The tone for monetary policy has turned increasingly dovish; the 10Y EU bond yield slumped to a new record low at -0.40%. The dovish legacy of outgoing ECB President Mario Draghi has been reassured with the appointment of IMF Chief Christine Lagarde as his successor. Lagarde's term starts immediately after UK's scheduled (possibly disorderly) exit from the EU on October 31. ECB Chief Economist Philip Lane, who previously headed the Central Bank of Ireland, is expected to play a larger role in steering monetary policy. However, the market still needs convincing that the ECB has the policy toolkit effective to deal with a Eurozone slowdown the Governing Council no longer considers a "temporary blip". After Draghi's surprisingly dovish stance at Sintra, the next ECB meeting on July 25 will be closely watched for any announcement on fresh QE as a sign of its readiness to do whatever it takes to achieve its inflation goal. **Against this background, the risk remains for a weaker euro towards 1.10 taking the DXY higher towards 98 again.**

Philip Wee

Equities — Fed cuts to bolster market sentiments, but not in all markets

Asian markets have found new relief on a few counts despite the ongoing trade wars in June. Critical for the benign investment environment are: 1) the USD strength which saw some weakening in June; 2) US bond yields which have dropped 50bps from early May; and 3) a more dovish Fed which has hinted at a near-term rate cut. Meanwhile, 4) economic data have continued to disappoint while growth recovery remains elusive. 5) Oil had mixed performance in June with tension building regarding the US and Iran situation amid demand worries.

Weak data bolster Fed cuts

As weak US economic data have bolstered expectations that the Fed will cut rates, we believe equity markets will continue to focus on monetary easing till the first rate cut occurs. We think it is likely to be in September as the US data are just not weak enough to justify a rate cut as yet. However, Fed futures are already almost pricing in a 100% chance of a rate cut in the next Fed meeting. **The tussle between growth and rate cuts will likely drive investors to rotate between the two benefitting groups – export-oriented or domestic-demand economies / sectors.**

Our base case assumptions are 1) two rate cuts in 2H; 2) 10-year bond yields rising back towards 2.2%; 3) US GDP growth of 2.5% in 2019; 4) USD to continue strengthening against the majors and Asia currencies; 5) Oil price recovery in the second half of the year. Although growth is slowing gradually, we do not see the beginning of an easing cycle to support growth, but just a couple of insurance cuts. The escalation of the US-China trade war is no more a material risk in our assumption.

These factors however, are all sensitive to each other's movements, and a Fed rate will likely have an impact in the interpretation of the outlook for the rest. For example, a Fed cut could be negative for the USD and also be interpreted as the US economy is weak, especially when the current data sets show mixed signals. Thus **we prefer to take a selective approach towards Asia markets and sectors as their responses to critical drivers differ.**

We believe **many economies will have the room to follow in the US Fed's footsteps**. Indonesia and Philippines had both hiked rates aggressively during the period when the Fed hiked rates last year. Likewise, we see the potential of these countries reversing their policies. Hong Kong and Singapore rates will likely follow the US interest rate trend. The property sector (including REITs) is likely to benefit from lower interest rates.

The following table summarises our assessment of the markets' response to key global drivers. **On balance, we believe China/Hong Kong, Singapore, Indonesia and Philippines will perform well under our base-case scenario.**

Joanne Goh

Summary of main macro drivers and market sensitivity

Critical drivers	Growth Slowdown	Fed cuts	Trade truce	Stable to lower oil price	USD strength if it reverses
Benefits the most / least affected	More resilient (domestic demand)	Room for policy rate cuts	Risk premium easing	Lower stress	Inflows
	India Indonesia Philippines	Indonesia Philippines India	China Singapore Taiwan	Indonesia India Philippines	Indonesia Philippines India
Most affected / Benefits the least	Most affected (export oriented)	Less room for policy rate cuts	Lower beta	Exposure to oil	Weaker currency strength
	Taiwan Korea Thailand	Taiwan Korea Malaysia	Malaysia Korea Philippines	Malaysia Singapore Thailand	Malaysia Hong Kong Singapore

Source: DBS

Rates: Revising lower our forecast for PH, KR and TH rates

We have brought down some of our Asian interest rates forecast. For Philippines, 2Y and 10Y rates are revised lower by 65-75bps, largely a marking-to-market against the massive rally in RPGB bonds. In 2019, 10Y RPGB has returned ~20% (bulk of returns came from price, minimal contributions from coupon and FX). While we expect Bangko Sentral ng Pilipinas to ease policy ahead (policy rate cuts, reduction to banks' reserve requirement ratios) and inflation to moderate further, we think rates are unlikely to move much lower. Current spreads against US Treasurys, a proxy for risk premium, are around fair (we believe 250-350bps range to be appropriate). Furthermore, with considerable uncertainties over global trade and growth, we are wary that any sharp deterioration in risk sentiments could disproportionately hurt high-beta bonds like RPGBs.

		REVISED		PRIOR	
Interest rate forecasts		end-2019	end-2020	end-2019	end-2020
Thailand	3m Bibor	1.85	1.85	1.85	1.85
	2Y	1.80	1.80	1.80	1.80
	10Y	2.30	2.50	2.60	2.60
Philippines	3m PHP ref rate	4.25	4.00	5.05	5.05
	2Y	5.10	5.00	5.75	5.75
	10Y	5.25	5.25	6.00	6.00
Korea	3m CD	1.55	1.55	1.76	1.76
	3Y	1.60	1.60	1.75	1.75
	10Y	1.95	2.25	2.05	2.00

For South Korea and Thailand, the revisions are much more modest. Both Bank of Korea (BOK) and Bank of Thailand (BOT) clearly stand out amongst regional and global central banks. Concerned by high household leverage and financial stability risks, they have yet to tilt dovish or give any clear signals of possible easing. With no noticeable improvements in economic momentum, one wonders how much longer they can hold out against the global wave of central bank dovishness.

BOK's reluctance to consider rate cuts is keeping markets guessing and Korean front-end rates volatile. Current levels are probably too low (3Y tenor at ~1.40%) due to markets' overly aggressive pricing of BOK rate cuts. We have penciled in only 1 cut in 3Q19 with none thereafter through end-2020. 3Y rates should grind higher to ~1.60% level.

10Y Thai rates are likely to trade in a tight range around US rates. BOT's relative hawkishness vs US Fed argues for higher Thai vs US rates. However, that could be offset by possibly substantial bond inflows ahead, investors likely drawn to greater political clarity post-elections and strength of the Baht (ytd 2nd-best in EM).

Duncan Tan

Highlights of the week:

Understanding India: Time is RIPE
Chart of the Week: Market reactions to US-China trade truce muted
Japan-Korea tensions pose new risks to electronics supply chains

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	0.9	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	3.4	3.5	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	2.75	2.75	2.75	2.75	2.75
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.80	1.60	1.60	1.60	1.60	1.60
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

	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.71	6.87	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.81	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.2	69.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14243	14126	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.13	4.25	4.23	4.21	4.19	4.17	4.15
USD/PHP	52.6	51.3	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.36	1.35	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1135	1155	1180	1170	1165	1160	1155	1150
USD/THB	31.7	31.0	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23189	23301	23500	23450	23400	23350	23300	23250
AUD/USD	0.71	0.70	0.64	0.66	0.68	0.70	0.72	0.74
EUR/USD	1.12	1.14	1.08	1.09	1.10	1.11	1.12	1.13
USD/JPY	111	108	112	111	110	109	108	107
GBP/USD	1.30	1.27	1.22	1.24	1.26	1.28	1.30	1.32

Australia, Eurozone and United Kingdom are direct quotes

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