Economics & Strategy Weekly

Weekly: Insurance cuts for what?

Economics/Strategy/Rates/FX/Equities

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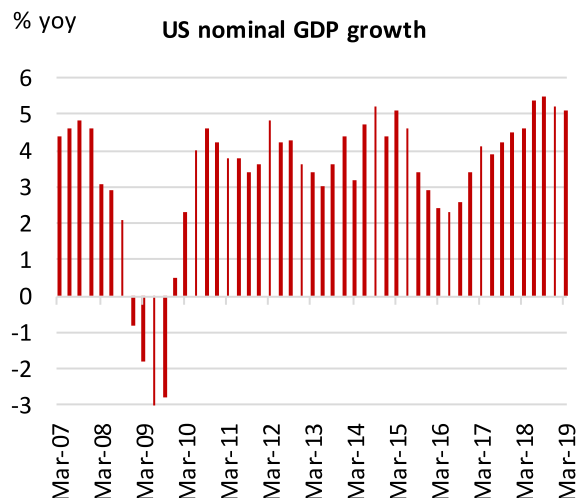
- *What are the risks of forthcoming rate cuts by the US Federal Reserve? Less room to cut when a real shock hits; asset price melt-up; policy credibility*
- *The intersection of high debt and high valuation will widen*
- *Expect increasing episodes of market tantrum as the Fed put is played out*
- *Fed cuts won't weaken the USD considerably*
- *Taking cue from the Fed, major central banks around the world will ease too*
- *Weak data out of China and Singapore show mounting downside to Asia's outlook*

Fed policy and melt-up risks

Federal Reserve Chairman Jay Powell May be secure in his job by constitutional mandate, he nevertheless seems to be doing the bidding for US president Trump. In Congressional testimony (for the semi-annual monetary policy report) overnight, the head of the US central bank could only point to general and tangential risks to the global outlook to make the case for rate cuts.

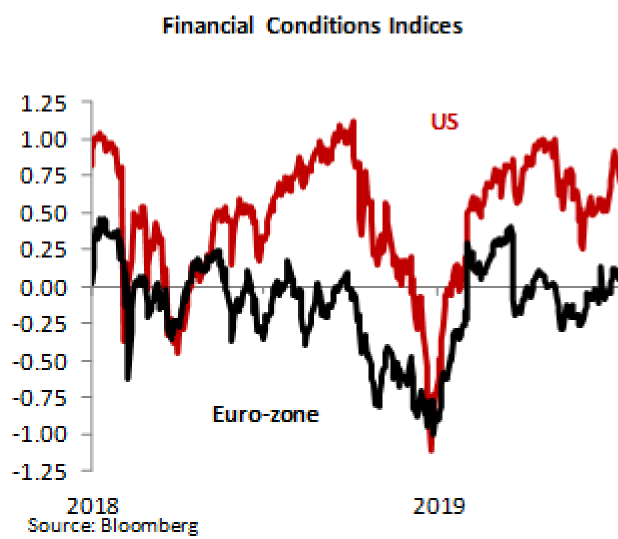
Absent were any concern on financial instability, unemployment, deflation, wages, or fiscal tightening. Indeed, financial markets are at record highs, unemployment at record low, inflation may be below target but nominal GDP growth is near the highest in the cycle (see chart below), businesses and consumer confidence markers, despite the gloom from trade wars, are only modestly dented.



Source: Bloomberg, DBS

DBS

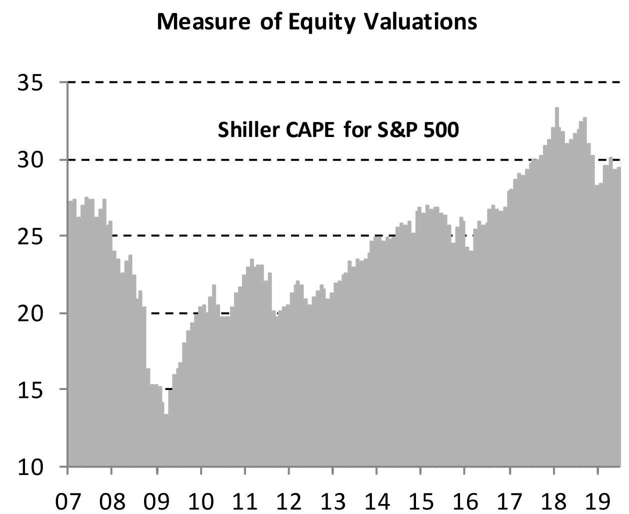
Against this background, the Fed is reaching for insurance as a hedge toward a weakening global outlook, and the markets are welcoming it. Our concern is two-fold. First, with markets at such heights, and yields already so low, an across-the-board asset price melt-up is a distinct possibility. This will make (if it already hasn't), differentiation between good and bad companies difficult, leading to likely mispricing of risk and misallocation of resources. At a time when debt stocks are already at record highs, and asset validation has spiked, financial fragility will build up inevitably.



Source: Bloomberg

It is not particularly difficult to see the seeds of fragility. Further weakening of the Chinese economy will lead to a powerful waning of demand for exporters of commodities and manufactured goods. Various business plans and asset allocation decisions that were based around continued strength of Chinese demand will therefore be challenged. Cyclical slowdown in auto and electronics demand will weigh in on the outlook, independent of Fed policy.

But the rationale for insurance cuts at this immediate juncture is questionable, in our view. The cushion against above risks can be offered by the Fed only if money market conditions tighten or risk aversion spikes. That is absolutely not the case presently worldwide. Also, as the cycle matures and a slowdown appears over the horizon, the Fed needs to keep ample powder in stock to act vigorously when real risks appear. Insurance rate cuts will reduce that stock prematurely.



Source: Rebert Schiller's webpage, DBS. Note: Shiller PE ratio for the S&P 500 is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted PE Ratio (CAPE).

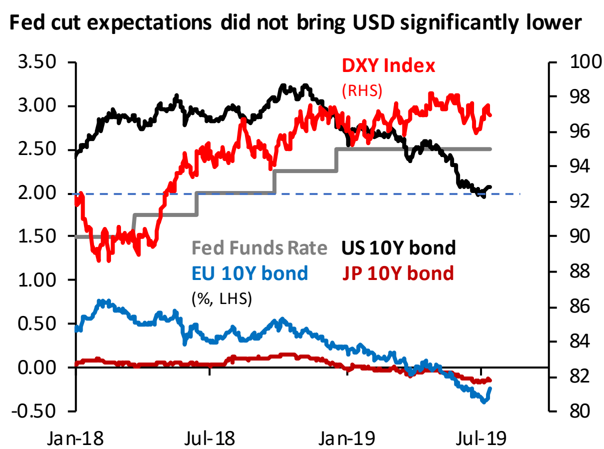
Perhaps the 2020 US elections are a critical subplot. If easing is an imperative, do it the year before elections and stay on the side-line, hoping the insurance cuts to extend the cycle. Such considerations are bound to lead to further complexities and distortions, in our view. Stimulated by the Powell put, the markets will incessantly demand more support after the 2019 rate cuts, in a repeat of tantrums seen in 2015 and 2018. As the Fed's hand is forced time and again, valuations will get loftier, creating the ground for more volatility and event risks. Watch out.

Taimur Baig

FX: Not carried away with Fed cut hopes

Expectations for a Fed cut in July did not weaken the greenback significantly. In fact, the USD Index (DXY) has held a steady 96-98 range after the US 10Y bond yield extended its fall below the Fed Funds Rate. Record high US stock indices and upside surprises in US jobs and inflation data suggest that markets were overly discounting recession cuts i.e. a 50bps cut in July. Fed Chairman Jerome Powell affirmed, at his semi-annual congressional testimonies this week, that the Fed was only looking for insurance cuts to sheathe the US economy from global headwinds. The most dovish FOMC member who voted for a cut at June meeting, St Louis Fed President James Bullard, expects the FFR to fall a total 50 bps to 2% by end-2019. Hence, the bond market is likely to have discounted what the Fed intends to do this year.

Fed cut expectations did not bring USD significantly lower

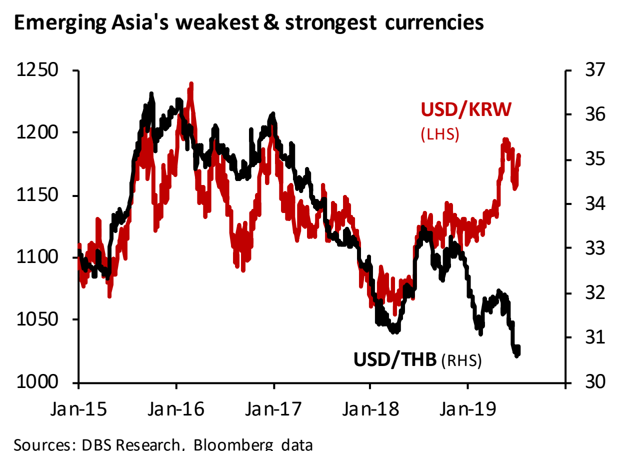


Sources: DBS Research, Bloomberg data

In the Developed Markets, there were no viable alternative currencies to diversify into. Eurozone bond yields not only turned negative but fell below their Japanese counterparts. The Bank of Japan pledged to maintain its ultra-easy monetary policy into spring 2020. The markets consider IMF chief Christine Lagarde a worthy dove to succeed Mario Draghi when his term as European Central Bank President ends on October 31. Both the ECB and the Bank of England consider the increased prospect of a disorderly Brexit a major risk to the economic outlook, one of the major considerations for their newly minted dovish stances. Pro-Brexit Boris Johnson has been leading the Tory leadership contest on a pledge to take the UK out of the EU with or without a deal. European Commission President nominee Ursula von der Leyen, a critic of Brexiter, has told German businesses to prepare for a no-deal Brexit.

Emerging Asian currencies, especially those in Southeast Asia, have benefitted from the weakness in DM currencies. The Thai baht remains the best performer (+5.5% ytd as of July 11), followed by the Philippine peso (+2.5%) and the Indonesian rupiah (2.3%). With inflation below its official target amidst negative export growth, the Bank of Thailand will be looking to lower rates to offset Fed cut expectations. In the Philippines, overheating fears have abated. CPI inflation has sharply retreated to 2.7% YoY June from its high of 6.7% last September, allowing Bangko Sentral ng Pilipinas to lower rates and the reserve requirement ratio. Bank Indonesia has yet to deliver the rate cuts it has signaled.

Emerging Asia's weakest & strongest currencies



Sources: DBS Research, Bloomberg data

The export-led currencies in Northeast Asia has depreciated the most so far this year, led by the South Korean won (-5.3%) with the Taiwan dollar (-1.5%) at a distant second. With S Korea's outlook dampened by Japan's ban on vital exports to Korea, the Bank of Korea is moving closer towards a rate cut. Similarly, China's GDP growth out on July 15 is expected to resume its slowdown to 6.3% in 2Q19 after holding steady at 6.4% for two straight quarters. The Chinese yuan has kept to a stable 6.85-6.90 range after the China-US tariff ceasefire struck at the G20 on June 29. There are still no signs of an imminent trade deal between the world's two largest economies. All things considered, we don't expect the strong risk appetite seen in 1Q19 after the first Xi-Trump trade truce struck last December.

Philip Wee

Rates: Insurance Fed cuts as the base case

The biggest takeaway for the week is that Powell is undoubtedly on the dovish side. US Treasuries were initially jittery in the aftermath of the blockbuster payrolls. However, with Powell's emphasis on the dimming outlook and increasing risks, couching several rate cuts for "insurance" purposes has become the base case. A few firm US economic data points is unlikely to prompt a stance change. **The first Fed cut in a decade is likely within this quarter and could come as soon as end-July.** Short-term USD rates undid most of the selloff that followed from the firm payrolls with the market assigning 24% odds of a 50bps cut and a 76% chance of a 25bps cut by the end of the month. Insurance cuts should amount to a cumulative 50-75bps over the coming year and this scenario is already reflected in the markets.

With such strong hints of imminent Fed easing, central banks across the world will take the cue. In Europe, ECB president Draghi has already opened the door to rate cuts and quantitative easing. Further details and dovish narrative could well come at the policy meeting on 25th July. **Risks of the European Central Bank (ECB) trying to outdove the Fed should not be underestimated.** This could have the effect of dampening interest rates across the EM (including Asia) space. **Odds of the Bank of Korea (BoK) and Bank Indonesia (BI) easing next week have ticked up.** Policy makers in these two economies have been more cautious than their Asian counterparts. However, with the financial market environment benign and economic data displaying weakness, rate cuts could well come sooner, rather than later.

Eugene Leow

Equities: More conviction on rate cuts, less on GDP growth

Market sentiments are likely to be kept buoyant by central bank puts. The will of central banks to do whatever it takes to pre-empt downside risks cannot be ignored. That said, growth data will likely worsen a lot more than expected in the near term for central bankers to be so overly concerned about growth.

Markets which have more room for easing and higher resilience in growth should perform well in this environment. We believe our Overweight markets of Hong Kong, Singapore, Indonesia and Philippines are well-placed.

In particular, Indonesia and Philippines are very likely to cut rates after the US Fed since they have both hiked rates aggressively during the US rate hike cycle. And they have lots of room for rate cuts, as inflation has been retreating and currencies have stabilised. Economic growth has been resilient, and likely to pick up in the second half with elections overhang removed in Indonesia, and Philippines approving its 2019 budget in April.

Bond fund flows attracted by widening yield spreads could make a case for the currencies to stay resilient. A reversal in the strength of USD upon Fed rate cuts would be the icing on the cake, although it is not our base-case scenario.

We continue to stay Overweight on Hong Kong and Singapore due to their attractive valuations. Growth in these two economies is likely to be downgraded to near 1% for 2019 after a poor 2Q GDP growth numbers. We believe that could mark the worst of downgrades as an escalating trade war is not a material risk event in our assumption but a tail risk. We think domestic companies will find ways to innovate and survive in this weak global environment, supported by government stimulus. China and Singapore have a lot of policy flexibility in providing support to their economies, compared with other countries.

Joanne Goh

Highlights of the week:

China Government Bonds: Unlikely laggards
Chart of the Week: Europe’s yield spreads

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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