Economics & Strategy Weekly

Weekly: Negative feedback loop

Economics/Strategy/Rates/FX/Equities

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- *Negative consequences of the ongoing trade war, amid a stretched global economic cycle, is becoming increasingly apparent.*
- *From China to Germany, trade and manufacturing data are weakening sharply. Pockets of stress in emerging markets are appearing.*
- *Asset markets are following suit, and risk aversion is spiking.*
- *The ongoing selloff is reinforcing already poor investor sentiment.*
- *US real economic data will likely be the next shoe to drop.*
- *A trade war cool-off is the only way out to prolong this cycle, but it may well be too late.*

When will the US shoe drop?

Data out of a wide range of economies, from China to Germany to Singapore, suggest that global trade and manufacturing are undergoing a torrid phase. Both electronics and auto demand are weak and overall investment sentiments are poor, thanks to escalating trade wars. Recent stress out of Argentina suggests that a low rates environment is not necessarily a panacea for emerging markets, with a period of heightened risk aversion creating a flight to safety toward safe assets that could pose difficulty for economies characterised by persistent current account deficits.

Amid this doom and gloom, the US, in contrast, is holding up rather well. This week's dataflow suggests that economic momentum is comfortably above 2% (annualised GDP growth). Retail sales were up a healthy 0.7% in July and earnings reports have been largely favourable. Pushing back against deflation fears, core inflation, on an annualised basis, is tracking at above 2%.

But can this bifurcation of a tranquil US versus a slowing rest of the world last? We are doubtful. Already, three key stress points are emerging:

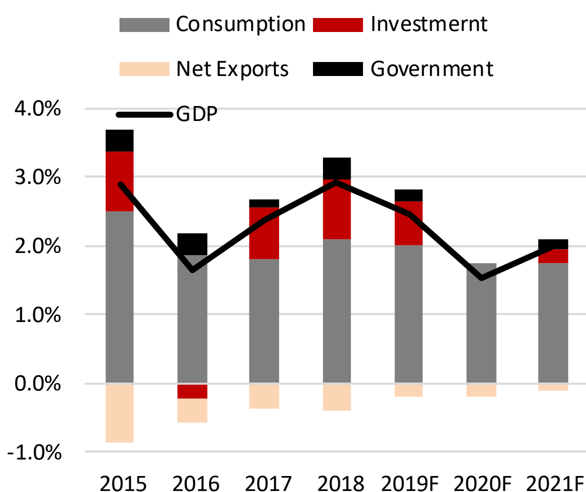
- First, as the Chinese economy slows and risks around its production being subject to sanctions remain high, global multinationals are seeing their sales and profits to the world's populous nation weaken.
- Second, the investment outlook has turned cloudy as little has been resolved with respect to various ongoing trade and currency conflicts (US-China, US-Europe,

US-Japan, Japan-S Korea, etc). This is causing much angst among investors and causing sentiment to worsen considerably.

- Third, the slowdown in global manufacturing and trade is beginning to weigh in on US business confidence. The agriculture sector, especially soybean producers, is feeling the brunt of the trade war, but electronics manufacturers are also looking at a potential loss of demand from China and likely headwind to sales from higher tariffs. US industrial production has joined the global trend, declining by 0.2% in July, prompting Atlanta Fed to cut the forecast for third-quarter real gross private domestic investment growth from 0.5% percent to -0.5%.

We have long expected an investment-slowdown led US economic correction in 2020, and short of a dramatic improvement in trade prospects, conditions are aligning for that. In our forecast chart below (extended through 2021), we see investment slumping next year, no fiscal stimulus in train, and slightly softer consumption, sufficient to take growth to a below-trend 1.5%.

US GDP growth and contribution from its components

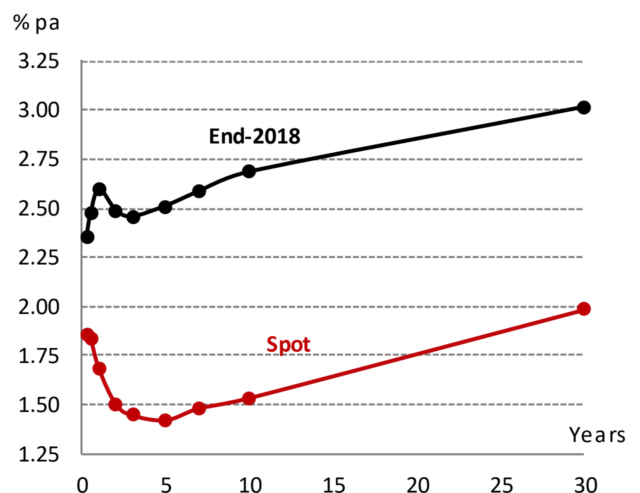


Source: CEIC, DBS

If we are looking at weaker growth, why aren't we forecasting more than 1 rate cut? We recognise that several rate cuts look likely, but we are not convinced by the market's narrative that inflation has disappeared from the horizon. Indeed, the same factors that make us worried about the investment horizon are also sources of upside risk to prices. As supply chains fragment, efficiency of production declines, as does the ability of the supply chain to absorb shocks. Nonetheless, we will take another look at our policy forecasts in the near term, as market pricing for rate cuts becomes increasingly aggressive.

Meanwhile, yield curves continued to sound alarm bells. The US treasury curve (and to a large extent, the Singapore rates curve) is pricing in a very weak growth and inflation outlook. Moreover, ongoing global developments have engineered a surge in flight to safety to US bonds. As per EPFR data, US fixed income mutual funds and ETFs are receiving over USD10bn a week lately. A trade war cool-off is the only way out to prolong this cycle, but it may well be too late.

US Treasury Curve



Source: Bloomberg, DBS

Taimur Baig

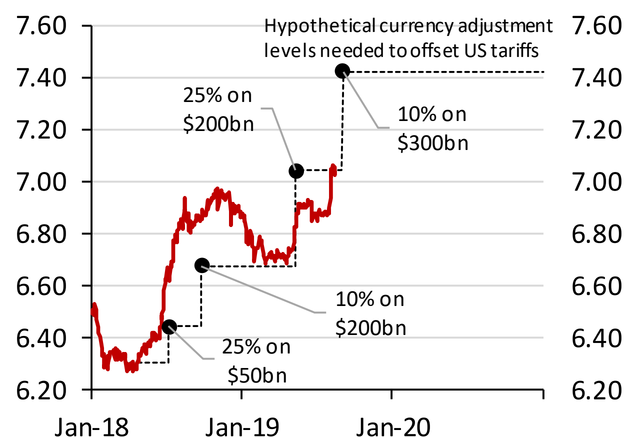
FX: We have downgraded our forecasts

The US dollar is now expected to remain supported for the rest of 2019. Admittedly, the greenback is also not as strong as before. US growth has come off its highs above 3% QoQ but remained resilient at 2.1% in 2Q19. On a relative basis, despite lower US bond yields, US growth risks still pale against recession prospects in Europe's largest economies – Germany, Italy and the UK.

The US dollar's strength has also been diluted by the shift from monetary policy divergences last year to convergences this year. After four hawkish hikes in 2018, the Fed has cut rates in July. Our forecast remains for another Fed cut in 4Q19. The European Central Bank is, however, expected to lower rates in September and restart asset purchases thereafter. The gilt market has been clamouring for the Bank of England to abandon its underlying hike bias in favour of rate cuts. Prospect for a no-deal Brexit on October 31 has, notwithstanding the political hurdles, increased under new British Prime Minister Boris Johnson and his cabinet of hardline Brexiters. **The euro and the British pound are expected to slide into lower ranges of 1.05-1.10 and 1.15-1.20 respectively** in the coming months.

US President Donald Trump's aggressive trade policies on China have hardened prospects of a prolonged trade war. Since May, Trump has lifted tariffs to 25% from 10% on USD200bn of Chinese goods, with another 10% on the remaining USD300bn coming on September 1 (of which some will be delayed to December 15). The US Treasury Department has labelled China a currency manipulator on August 5 after the first round of China-US trade talks in Shanghai in late July ended in mutual criticisms.

How USDCNY has risen with US tariffs



Sources: DBS research, Bloomberg data

The Chinese yuan has depreciated past 7 against the USD, in line with currency adjustment levels hypothetically needed to offset the 25% US tariffs on the USD200bn of Chinese goods so far. **Our forecast for USDCNY to end 2019 higher at 7.20 reflects the scheduled US tariffs on the USD300bn.** Even so, we remain vigilant of "possible but improbable" surprises from Trump moving to de-escalate trade tensions that threaten the US economy and his reelection bid next year.

Singapore's official growth forecast for 2019 has been lowered to 0-1% from 1.5-2.5% previously. In QoQ saar terms, Singapore's growth contracted 3.3% in 2Q19, its second negative growth in three quarters. **We expect the Singapore dollar policy to ease at its next policy review in October.** This should drive the SGD NEER into the lower half of its policy band, which according to our model, should imply a USDSGD rate of 1.39-1.42.

Philip Wee

Equities: Hong Kong listed equities a bargain

The Hong Kong Hang Seng Index has retreated 11.4% since July till 15 August as the Hong Kong protest turmoil enters its tenth week. To be sure, the Hong Kong market has already been battling headwinds brought about by the trade war, and the protests are adding downside risks to the Hong Kong economy. As it is now, our GDP growth forecast is already at 0% for 2019, and 2Q19 GDP growth was at -0.3% q-o-q. The protest demonstration, if extended for beyond three months, could push Hong Kong to a full-year recession, in our view.

Despite the unrest, we remain constructive on Chinese equities. As the overall market remains inexpensive from a P/E, P/BV and dividend yield perspective, we believe there are opportunities for investors if they focus on sectors which are least impacted by the trade war, Hong Kong unrest, and sectors which offer secular growth. We estimate that about 20% of aggregate earnings of Hang Seng Index component stocks are derived in Hong Kong and will be affected by the protests.

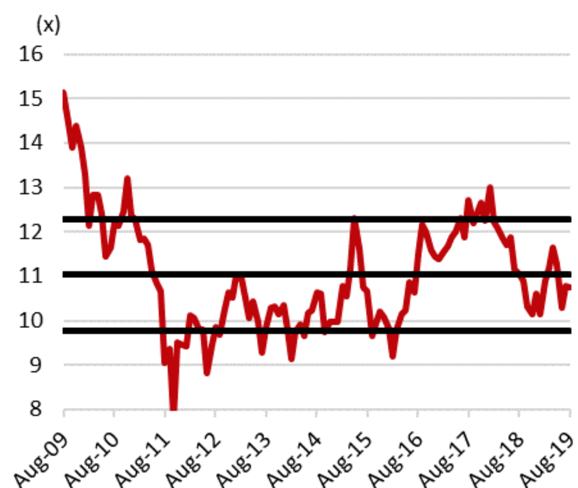
Sentiment-driven market sell-offs are usually brief and subsequent recoveries swift. Since the 1980s, Hong Kong had come across several unsettling events that caused the HSI to plummet. They were the Sino-British Joint Declaration (1983), Tiananmen Square Protest (1989), Handover of HK (1997), and Umbrella Movement (2014).

While there are no signs of an imminent resolution to the unrest, our base-case scenario is to see the protests subside by 1 October which is the Chinese National Day.

Conversely, if violence continues to escalate, curfews may be imposed in certain areas and the impact on the economy will be affected across sectors such as consumption, tourism, transportation, property, and spill over to the labour market and wage growth. We believe further market de-rating is likely if the situation drags on.

We maintain our positive long-term stance on the China/Hong Kong market. Even though market volatility is expected to remain high in the near-term, fundamental tailwinds from stimulative global and domestic monetary policies, on the back of increasing China weighting in international benchmarks will be supportive. We believe Hong Kong will retain its position as a feeder for international finance and trade flowing between the mainland and the rest of the world. Investors can look into secular growth themes in China e-commerce and insurance stocks while banks offer attractive dividend opportunities.

Hong Kong Hang Seng Index — 12-month forward PE valuations

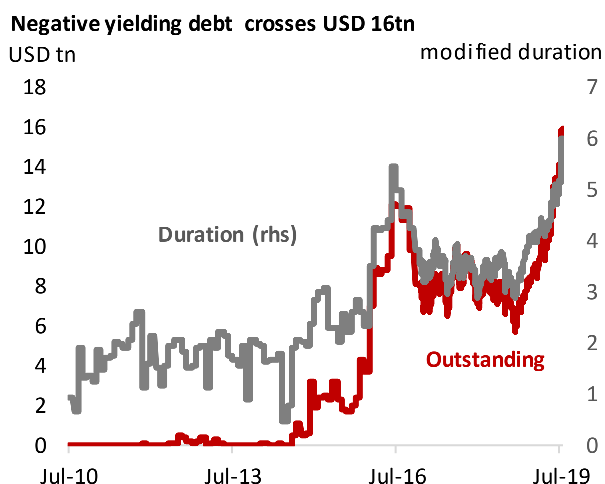


Source: Thomson Reuters

Joanne Goh

Rates: Ominous signs

Sentiment soured this week as market participants focused on the increasing list of worries that that global economy has to deal with. Trump's decision to postpone tariffs on selected Chinese imports did not assuage market concerns as weak Eurozone and Chinese data weigh. Meanwhile, **recession warnings from the US bond market got louder as 10Y and 30Y yields touched 1.52% and 1.97% respectively.** With US's macro numbers staying firm, we argued that it would probably require tightening in financial conditions to prompt urgent Fed action. We could be close to this point if the equity market sells off further.



We maintain our neutral stance on USD rates. Rates are very low by recent standards, but it still makes sense to have some exposure in US Treasuries given the highly uncertain outlook. Moreover, USD rates remain attractive compared to developed market peers. The technical picture (key support levels broke for USTs) and mismatched supply and demand in the DM space (USD 16tn of negative yielding bonds) suggest that there is further downside to US yields. It probably would not take much bad news to drive 10Y US yields back towards its all-time low of 1.36%. However, investors should also bear in mind that the bond market rally looks stretched. An overweight duration stance is vulnerable to any good news that has been sorely lacking in recent months.

Eugene Leow

Highlights of the week

- *Indonesia: Surfacing economic weakness*
- China: Slowing growth; more stimulus to come
- Navigating the sovereign bond landscape
- India: Is a coordinated policy response likely?
- Japan: 5 challenges in the second half
- Singapore's dour growth outlook
- Chart of the Week: Divergent China/US/EU dataflow

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	0.0	0.5	1.5	2.5	2.7	2.5
India*	8.2	7.2	6.8	6.8	4.5	3.6	3.4	3.6
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.2	3.4
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	0.7	1.8	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	0.5	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	0.8	0.7	0.5	0.5	1.0	0.8	1.3
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	5.40	5.25	5.25	5.25	5.25	5.25
Indonesia	6.00	6.00	5.75	5.75	5.75	5.50	5.50	5.25
Malaysia	3.25	3.00	3.00	2.75	2.75	2.75	2.75	2.75
Philippines	4.75	4.50	4.25	4.00	4.00	4.00	4.00	4.00
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	1.25	1.25	1.25	1.25	1.25
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
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	7.10	7.20	7.15	7.10	7.05	7.00
USD/HKD	7.85	7.81	7.85	7.85	7.85	7.84	7.84	7.83
USD/INR	69.2	69.0	71.0	71.5	72.0	72.5	73.5	74.0
USD/IDR	14243	14126	14450	14500	14550	14600	14650	14700
USD/MYR	4.08	4.13	4.22	4.25	4.24	4.23	4.22	4.21
USD/PHP	52.6	51.3	53.3	53.6	53.9	54.2	54.5	54.7
USD/SGD	1.36	1.35	1.40	1.42	1.41	1.41	1.40	1.40
USD/KRW	1135	1155	1230	1250	1240	1230	1220	1210
USD/THB	31.7	31.0	31.0	32.0	31.8	31.6	31.4	31.2
USD/VND	23189	23301	23200	23220	23250	23270	23300	23330
AUD/USD	0.71	0.70	0.66	0.64	0.65	0.65	0.66	0.66
EUR/USD	1.12	1.14	1.10	1.08	1.09	1.09	1.10	1.10
USD/JPY	111	108	107	109	109	108	108	107
GBP/USD	1.30	1.27	1.18	1.16	1.17	1.18	1.19	1.20

Australia, Eurozone and United Kingdom are direct quotes

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