Weekly: Watch out for another market tantrum

Economics/Strategy/Rates/FX/Equities

DBS Group Research

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- *A major point of divergence between the Federal Reserve and global markets is opening up.*
- *The fixed income market is pricing in 100% chance of a rate cut in mid-September.*
- *But just this week, four regional Fed presidents have expressed reservations about the need for further policy easing in the near term.*
- *We may well be heading toward an episode when markets sell off sharply ahead of the September 17-18 FOMC meetings to force the Fed's hand. Fasten your seatbelts.*

Fed confusion and a potential market tantrum

Market indicators keep flashing recession signals (with the widely followed 2Y-10Y treasury spread turning negative several times in recent weeks), but looking at real economic data from the US, there is little sign whatsoever. Through the month of August, Atlanta Fed's Nowcast has steadily raised its estimate for 2Q GDP (starting the month at 2% and now tracking 2.2%). This has been driven by stronger-than-expected retail sales and residential investment data. Add to this the strong jobless claims report for the week ending August 17, fears of the ongoing trade war spilling over into the US economy have so far not materialised, especially with respect to consumption.

This sets up a major point of divergence between the Federal Reserve and global markets. Affected by progressive slowdown in China and EU, whiplashed by trade wars, concerned about various pockets of geopolitical flashpoints, and finally, alarmed by the sharp ongoing slowdown in the global auto and electronics sales, developed market bond yields have declined sharply and many central banks have started cutting rates. But as the far as the US is concerned, the Fed sees steady growth of GDP, wages, and jobs, stable financial markets, as well as moderate inflation. From that vantage point and given its mandate, Fed officials are increasingly struggling to live up to market expectations.

This week's Fed-speak underscores this struggle amply. Four regional Fed presidents (George, Rosengren, Harker, and Kaplan) have spoken about the US economy not in need of immediate policy easing, in line with Chair Powell's argument made in July that last month's rate cut was nothing more than a mid-cycle adjustment, as opposed to the beginning of a rate cut cycle.

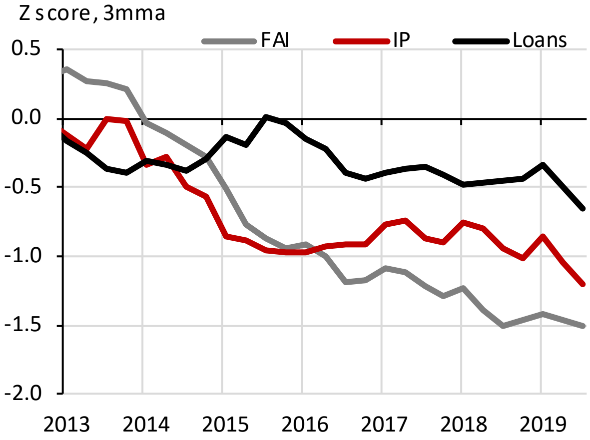
With the markets certain about a September rate cut, and the Fed sounding not certain at all, we are heading toward an episode when assets sell off sharply ahead of the September 17-18 FOMC meetings to force the Fed's hand. Fasten your seatbelts.

Tracking China and India's growth momentum

What's the best way to visualise the ongoing slowdown in Asia's two largest economies? Below we present a set of high frequency indictors (normalised as z-scores) that are the best statistical proxies of China and India's GDP. Indeed, these variables make up the core of our Nowcasting exercise. In addition to actual data, the charts also depict our model-based forecast for 3Q19 for the respective indicators.

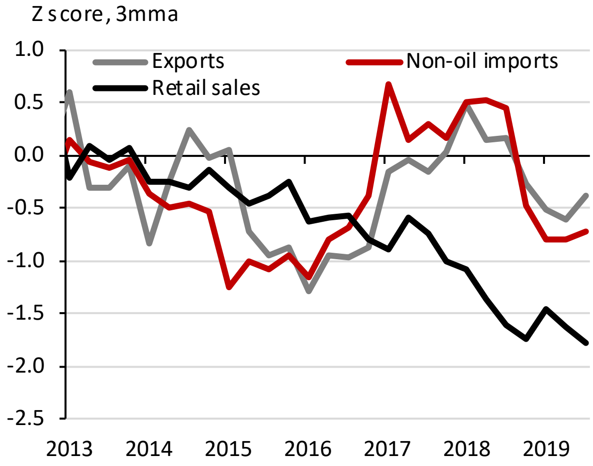
These charts speak volumes. Compared to the exuberant days five years ago, both economies are characterised by across-the-board and historically weak growth momentum.

China: FIxed asset investment, industrial production, and credit growth



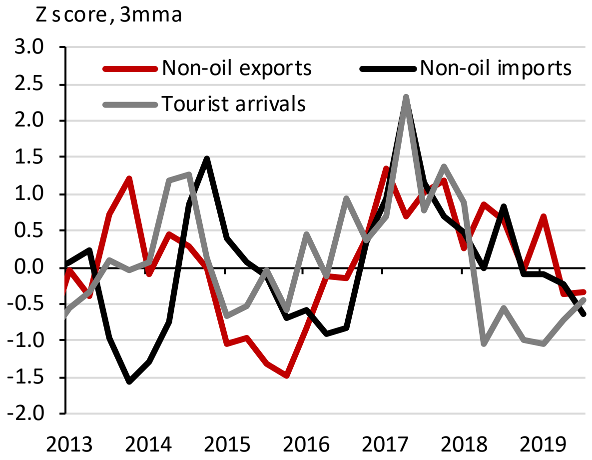
Source: CEIC, DBS

China: trade and sales



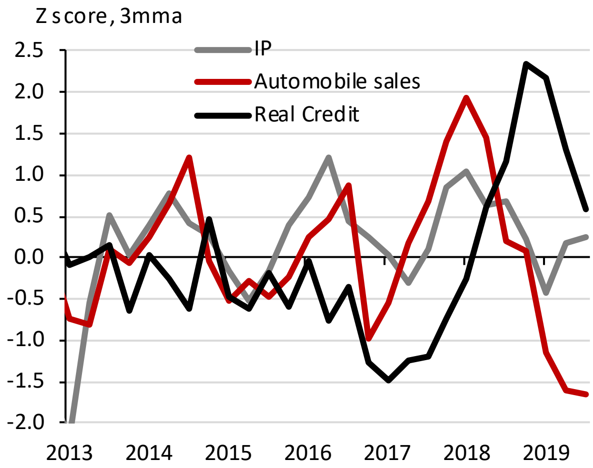
Source: CEIC, DBS

India: trade and tourism



Source: CEIC, DBS

India: sales, credit, and industrial production



Source: CEIC, DBS

Taimur Baig

FX: EUR & CNY weak, IDR stable

Barring any dovish surprises at the Fed's Jackson Hole Symposium on August 23, the USD is likely to stay strong relative to its weaker European peers. The European Central Bank will be more aggressive at its next meeting on September 12, in delivering not only a rate cuts but also announcing a stimulus package. In the UK, Prime Minister Boris Johnson has demonstrated more determination than his predecessor (Theresa May) in overcoming the political hurdles to deliver Brexit on October 31, with or without a deal. The risks remain for EURUSD and GBPUSD to trade below 1.10 and 1.20 respectively.

The Chinese yuan has yet to stop depreciating after breaking its psychological 7 level earlier this month. The mid-rate for USDCNY, at nearly 7.05 August 22, was the highest level since March 2008. Our end-2019 target of 7.20 is based on the 10% US tariff set to hit the remaining USD300bn of Chinese goods on September, of which tariffs on some goods will be delayed till December 15.

Look for the Indonesian rupiah to remain within its stable 13900-14500 range this year. Against the Argentine peso's plunge and the yuan's ongoing depreciation, Bank Indonesia has surprised with a back-to-back rate cut on Aug 22, a testimony to its commitment to rupiah stability via accommodative monetary and macro-prudential policies. Other notable signs of policy credibility included the debt rating upgrade by S&P after the re-election of President Widodo, and Sri Mulyani as FinanceAsia's best finance minister of the year.

Philip Wee

CNY Rates: Govvies are attractive

China govvies are attractive in this low yield environment. China government bonds have underperformed US Treasuries significantly with the yield premium in the 10Y tenor widening out to 142bps (compared to 59bps at the start of the year). This seems counterintuitive given that Chinese data (retail sales, industrial production and loan growth) have been showing much more signs of stress compared to the US. However, this neglects the point that the People's Bank of China (PBoC) has been more cautious in disbursing monetary stimuli in the current slowdown compared to previous economic downturns. Notably, the weighted average OMO rate and the 7D repo have been heading sideways as the PBoC keeps liquidity neutral. **We still think that targeted easing is in the offing,** which could spark more sizable capital gains in govvies. **Even if that does not materialise, we think that returns from coupons should still be sufficient to entice investors.** We have re-centred our China rates forecasts to be in line with our recently revised G3 figures.

Interest rate forecasts		end-2019	end-2020
China	1 yr Lending	4.35	4.35
	3Y	2.70	2.70
	10Y	2.80	3.00
	10Y-3Y	10	30

Eugene Leow

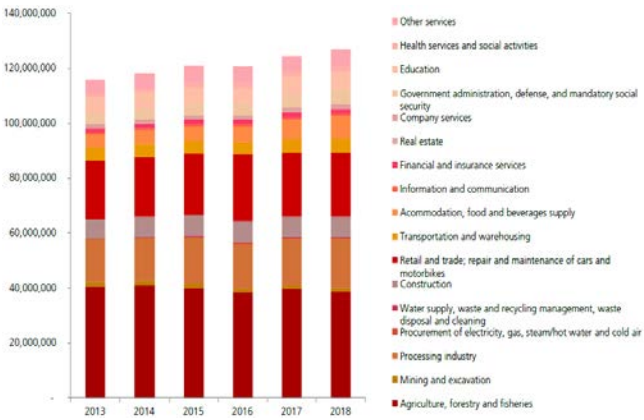
Equities: Weak commodity prices positive for margins, negative for Consumption — Stock selective in Indonesia Consumer sector

The Indonesian consumer sector's performance was a mixed bag in the first half, with staples generally faring better than the retailers. While enjoying margin improvement from lower commodity prices, the staples sector also benefitted from pre-elections and pre-Lebaran festive season spending. The retail sector however disappointed, even for those players targeting the low-to-middle income group. We think this is largely due to weak commodity prices affecting spending power.

Based on our findings, several agricultural commodity prices such as crude palm oil (CPO), rubber, coffee and cocoa have a strong impact on Indonesia's household income and thus consumer spending. Given that some 38 million Indonesians are farmers and nearly half of them are in these sectors, and that these key commodities are currently at cyclical lows, consumption purchasing power, especially those outside Java could have been affected.

With the absence of public holidays and political events, as well as weaker commodity prices, we expect consumption growth to be more benign in 2H19. We are thus selective in the Indonesia consumer sector, preferring consumer staples that can benefit more from the lower commodity prices and at the same time with resilient brands that they can grow market share. On retail, we prefer retailers that target the middle-upper class with more stable discretionary income (as opposed to those dependent on commodity prices), and those that have an omni-channel strategy to capture the growing online sales trend.

Indonesia — Employment by sector/people



Source: BPS

CPO price (MYR/MT)

Source: Bloomberg Finance L.P.

Joanne Goh

Highlights of the week

- Indonesia: Another pre-emptive rate cut
- G3 Rates: Seeking refuge
- Chart of the Week: Hong Kong's retail sales and tourism downturn

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