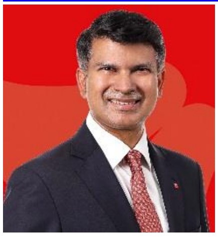
Volatility and market structure

DBS Group Research 21 September 2018

Taimur Baig
Chief Economist
taimurbaig@dbs.com



Radhika Rao
Economist
radhikarao@dbs.com

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *Bond market sell-off has taken place in strikingly low trading volume*
- *A further rise in volatility is likely given the macro outlook, but would likely be exaggerated by the market structure*
- *Non-bank financial sector has taken on some chunks of risk taking activities from banks*
- *Post-crisis regulatory environment may have made banks safer, but not the entire financial system*

Bond market pressure driven by factors beyond macro

We are heavily engaged with clients these days on subjects ranging from trade wars to EM sell-off. There is a heightened sense of unease, driven by uncertainty about the economic and financial market outlook. On one hand, domestic demand is sound in most parts of the world, despite a rise in energy prices and tightening liquidity conditions. On the other hand, financial markets look fatigued in some places and downright stressed in many EM economies. Trade wars may be dominating the headlines, but it is increasingly seen as a China-US matter. Causing more stress is the rising US policy rate and tightening of liquidity.

In our conversations with regulators and market participants in recent days, we have picked up a common refrain. **Recent sharp sell-offs of the government bonds in Argentina, Italy, Indonesia have all taken place with strikingly little volume**. The large price movement has nevertheless left many asset managers (particularly real money) with considerable mark-to-market losses, which means that even if they see emerging value in some bonds, they will not be in a position to bid for them.

This bodes ill for the countries that need to come the market for fresh issuance in the coming months. The search for yield may not have diminished, but the ability to take on risk has, which will probably push up market clearing yields considerably.

Why are we in this situation? Well, it is largely a legacy of the 2008 global financial crisis. Led by the US, but followed fervently by Europe, regulations have increased bank capital buffers (good), reduced risk appetite (good and bad), and reduced trading volume (again, good and bad). Banks, traditionally the market maker through their proprietary trading desks, have largely stopped pursuing such activities. When a bond buyer comes to the market, banks seldom take them up and warehouse them. Instead they strive to pass on the risk to another buyer, availability and appetite of whom can be highly variable.

This is a key reason why bid-ask spreads have steadily widened in recent years, culminating in a major widening lately as market stress has risen. With banks no longer playing an active role in the middle and liquidity declining, investment firms have become a bigger holder of risk, without seeing a commensurate rise in returns.

Since no regulatory changes are in the pipeline to alleviate this dynamic, we can expect more volatility and higher cost of funding in the coming year. The matter is further complicated by the fact the many countries have large financing and refinancing needs next year due to rising energy prices (affects the current account) and a sharp increase in borrowing (hence, ballooning short term debt on a residual maturity basis) in recent years.

Related to this development is the rapid growth of the non-bank financial sector in the past decade. As banks have de-risked, risk has migrated to the balance sheet of fund managers, and brought in numerous non-banks into the business of lending.

We have two areas of concern. First, private equity companies, funded by foreign capital, have become involved in lending in large projects in emerging markets. These loans have FX mismatch embedded in them; ongoing sell-off in EMFX makes them more onerous to service. Second, non-bank financial companies, with the help of fledgling financial technology, have been extending an array of loans to households and SMEs, ranging from auto financing to mortgages. The next wave of defaults could well come from this area, as rates rise.

There is a troubling gap in supervision in this context. Most central banks focus on bank supervision directly, while monitor non-banks only in the framework of overall financial stability assessment. Indeed, given the light touch regulatory application on the non-bank financial sector, the question is if there is a degree of regulatory arbitrage driving its expansion while reducing the regulator’s visibility of risk build-up. From a surveillance perspective, central banks tend to track bank credit growth, but at a time of fast expansion of non-banks, the metric has begun to lose its value. A glaring case in point is India, where in 2017 most financial system credit was generated in the non-bank financial sector (bond issuance and NBFC lending), with its beleaguered banks accounting for just 48%.

Financial crises occur with regularity simply because regulation tends to fight the last one, while risk migrates somewhere else. Since the GFC, banks have become undoubtedly safer, but that has not mitigated the risk of an asset price boom-bust cycle. Over the past decade, we have seen household debt surge in the US, corporate debt jump in China, and EM borrowings spike. As rates rise and debt service distress mounts, the balance sheet of the non-bank financial sector may well be the Canary in the coal mine, an inadvertent result of the post crisis regulatory environment.

Taimur Baig

Strategy

FX: Keeping faith in the USD

The market is assessing how much lower the USD Index (DXY), which has traded below its 100-day moving average this week, **can correct in the near term**. This would help to clear out the weak long USD positions and **provide USD bulls a better level around 92-94 to push the DXY into a higher 95-100 range** in 4Q18. We believe that USD bears are underestimating the risks from China-US trade tensions, and overly optimistic on Brexit and Italy.

There have not been any significant changes in the **medium-term fundamentals that favour the US** over its peers. This week, major US stock indices hit new record highs while the US 10Y bond yield rose above 3%. The ground is set for the Fed Funds Rate to increase a third time this year by 25 bps to 2.25% at next week's FOMC meeting on September 26. The Fed is likely to reaffirm the stance to gradually increase rates, not only in 4Q18 but also into 2019. Against this background, **USD bears looking for a pause in the Fed hike cycle are likely to be disappointed**.

Washington and Beijing have and will continue to agree to disagree on trade. US President Donald **Trump's tariffs on another USD200bn** (vs USD50bn in July-August) **of Chinese goods** entering the US from September 24 **did not trigger another sell-off in the Chinese yuan**. This was attributed to Chinese Premier Li Keqiang's pledge not to weaken the exchange rate to boost exports. **That said, there was no rush to buy back the yuan.** China's policy responses to cushion the economy from increased trade tensions would not stop growth from slowing and its current account and fiscal balances from weakening. More so if Trump follows through with his threat to impose tariffs on the rest of Chinese goods into the US, possibly ahead of the US mid-term elections scheduled for November 6. **USD/CNY is more likely to consolidate in a 6.80-7.00 range than to reverse trend.**

On Brexit, British PM Theresa May appears to be able to achieve a deal with UK lawmakers or Brussels, not both. Ever since her gamble at the 2017 elections backfired, PM May has been fending off leadership challenges from her Conservative party (Tories). Lately, the opposition Labour Party believes that it can win the next election by backing a second referendum on Brexit. The Irish border remains a contentious issue in negotiations with the EU. Why else would UK and EU push the deadline to agree on a Brexit deal out to the Salzburg Summit in mid-November. In summary, all sides are still muddling through Brexit, which has moved the debate from "Hard or Soft Brexit" to "Deal or No Deal Brexit" towards what is increasingly looking to be a "Blind Brexit". Hence, the **British pound's latest recovery is more likely a USD correction story than one pointing towards a favourable Brexit outcome**. We still see GBP/USD eventually moving lower into a 1.25-1.30 range this year.

In a same vein, Rome and Brussels are on a collision course over Italy's fiscal plans. The newly-elected Italian government wants to widen the fiscal deficit to 2-2.5% of GDP to fulfil its growth pledge to voters. On other hand, EU is not letting up in ensuring that Italy keeps the gap below 2% to improve or keep its structural deficit stable. Meeting EU's demands would undermine the unity between the far-right and anti-establishment parties within the coalition and open the prospect of fresh elections next year. Hence, we don't share the euro bull's optimism on Italy. We see the **upside for EUR/USD capped at 1.18** (or 1.20 at most) **before reality drives it down to 1.10-1.15** in 4Q18.

Philip Wee

Rates: UST 10Y breached 3% despite tariff escalation

Despite a significant escalation in US-China trade tensions this week, global rates markets seemed rather sanguine with little evidence of flight-to-safety flows. Post the Trump administration's announcement of new tariffs on USD200bn of Chinese goods (to take effect Sep 24th), UST yields tick higher in a steepening fashion. We think markets were prepared for an immediate 25% tariff rate and thus were somewhat relieved to get 10%. The UST 10Y yield broke past 3%, closing at 3.06% yesterday.

Attention will now turn to likelihood of further escalation. In the following days, US President Trump could initiate the next round of tariff action (remaining USD267bn) which would then cover almost all of China's exports to the US. If the above sequence of events play out, we could see markets swing into risk-off mode and UST yields pull back. We also prefer to fade this week's re-steepening of the UST curve (2Y/10Y: 6bps, 5Y/30Y: 3bps). **The drivers for long-term flattening trend are still intact**, in our view.

The reaction of Asian rates has been rather muted despite the region's exposure to China. Chinese Premier Li Keqiang's comments on Wednesday where he ruled out active devaluation of the yuan (key risk event for Asian markets) likely helped to cushion the impact. We are also beginning to see some signs of stabilization within the Asian rates complex. Indeed, **the increase in Asian rates this month has been chiefly driven by higher US rates and not outflows or EM contagion**. Even in the more vulnerable markets of Indonesia and Philippines, key funding rates and sovereign bond yields are coming off elevated levels.

Duncan Tan

Equities: Wind shift in favour of Thailand vs Malaysia

Malaysia's Budget 2019 could disappoint

The Malaysian stock market outperformed regional markets in 3Q18. Bank stocks accounted for the large part of the 6% rally in the Kuala Lumpur Composite Index (KLCI). The broader Malaysian market remained lacklustre on disappointing 2Q18 corporate earnings and slower GDP growth. We have cut our earnings growth from 9.1% to 5.8% for FY18 and GDP growth for this year from 5.4% to 4.8% following the results. Near-term, we believe that the upcoming Budget 2019 in November could disappoint as government spending is likely to be crimped as more debt positions unravel in Malaysia.

Malaysia's valuation at 17.2x PE is at a 51% premium to the region, at/near all-time highs. Short of earnings growth to drive the index, we believe any re-rating is quite unlikely.

We are Neutral but not outright negative on Malaysia. The country has a current account surplus and should not be lumped with other countries with current account deficits. Uncertainty over the fiscal gap of the nation has eased after Fitch reaffirmed Malaysia's "A minus" sovereign credit rating. As the only net oil exporter in Asia, Malaysia stands to benefit from higher oil prices.

We expect private consumption to contribute positively to GDP growth in 3Q18. The Sales and Services Tax (SST) has been reintroduced after the government repealed the Goods and Services Tax (GST). The government has also standardised minimum wage. We like Banks as a consumer proxy.

Thailand's recovery is gaining traction

The Thai market outperformed regional peers which dropped 2% on average. The positive sentiment was partly helped by decent 2Q18 corporate earnings, which grew 17% y-o-y. Foreign investors, however, remained net sellers amid the panic in emerging markets, fears of trade war, and global monetary policy normalisation. In fact, selling activities in the Thai market was the highest among all Asia ex-Japan markets by foreign investors.

The stronger market performance in Thailand was helped by positive domestic sentiment. The Thai economy expanded 4.8% y-o-y in the first half. The stronger agricultural production was supported by favourable weather conditions, adequate water, and higher demand from both domestic and exports. This led the Farm Income Index to post its first positive growth (6.1% in 2Q18) in four quarters. The government has also proposed to continue with the VAT return scheme for the poor to help cope with living costs. We believe consumption recovery can be sustained.

The monetary policy committee (MPC) is paving the ground for a rate hike on an improving economic recovery that has gained traction this year. We think a rate hike should be as a positive sign of Thailand's emergence from its low growth trap.

Thailand has stood out among Asian countries in many ways during the recent volatility. Thailand's current account surpluses is strong around 10% of GDP. Its fiscal position reversed into small surplus in 2017 after a deficit in 2016. These favourable factors have helped foreign investors (who account for ~15% of the domestic bond market) to keep faith in Thai bonds during the global bond sell-off. The baht was flat this year against a field of depreciating currencies in the region.

Like Vietnam, Thailand stands to benefit from a strong pick up in foreign direct investment (FDI) in the next few years. Chinese companies and traders, who used to source from China, need to diversify out of the mainland. Thailand has a very competitive rating for ease of doing business and an exports sector that is broad-based.

We are upgrading our view on Thailand. Near term, foreign fund flows which have been absent from the market during the year, could also return in anticipation of elections by 1Q19.

Joanne Goh

Credit: Opportunities in new Asian bank bonds

It was a busy week for the primary bond market in Asia. Among the new bond issues, deals from banks in the region, both in the senior and subordinated debt space, have presented opportunities for investors looking for yield. Two notable recent senior bond issues included BBB-rated 5Y bond deals from a Philippine private bank and an Indian state-owned bank. Both bonds were priced in the mid to high 4% area and offered some rarity value. Philippine banks are not frequent issuers in the market. The Indian bond deal was just the second issuance this year. The bonds have held up well in the secondary market. We consider, in the context of investment grade bonds, the pricing to be fairly attractive.

The week also saw a couple of SGD-denominated subordinated bond issuances (both Tier 1 and Tier 2). Subordinated bank debt is a sector where we see some value (Monthly dated August 31). Middle East banks have also been active in the sub-debt space with recent USD-denominated AT1 issuances from an Abu Dhabi and a Kuwaiti bank, both in the 7% handle. In contrast to high grade issuance, high yield issuance continues to be a challenge for investors with most of the supply coming from repeat issuers, especially out of China. With these issues generally pricing well wide of secondary market levels and, hence, repricing existing bonds, supply remains a technical weakness for the market. The sought-after quality BB issuances are still missing in action.

The coming week could see some slowdown in activity, due to the upcoming FOMC meeting on 25-26 September, and a China holiday on 24 September. Bond markets, which have so far taken the increase in 10Y UST yield in its stride, will be looking for the tone of the comments coming out from the Fed. Focus will also be on China, where the redemption of a USD300mn LGFV bond on 26 September still remain an evolving situation. The bond was bid at around USD94 at the time of writing, indicating market is still pricing in a successful redemption. The development of this situation will be important for market's assessment of other LGFV credits, and indeed, of weaker Chinese credits in general.

Neel Gopalakrishnan

Highlights of the week: *Taiwan: Growth outlook lowered on higher trade tensions*

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2016	2017	2018f	2019f	2016	2017	2018f	2019f
China	6.7	6.9	6.6	6.2	2.0	1.6	2.1	2.2
Hong Kong	2.0	3.8	3.3	2.9	2.4	1.7	2.0	2.5
India*	8.0	7.1	6.7	7.4	4.9	4.5	3.6	4.7
Indonesia	5.0	5.1	5.0	5.2	3.5	3.8	3.6	4.0
Malaysia	4.2	5.9	4.7	4.5	2.1	3.9	1.3	2.5
Philippines**	6.9	6.7	6.7	6.7	1.3	2.9	6.0	5.5
Singapore	2.0	3.6	3.0	2.7	-0.5	0.6	0.7	1.8
South Korea	2.9	3.1	2.9	2.9	1.0	1.9	1.5	1.8
Taiwan	1.4	2.9	2.7	2.2	1.4	0.6	1.3	1.0
Thailand	3.2	3.9	4.0	4.0	0.2	0.7	1.5	1.5
Vietnam	6.2	6.8	6.4	6.6	2.7	3.5	3.6	3.8
Eurozone	1.8	2.5	2.2	2.2	0.2	1.5	1.4	1.4
Japan	0.9	1.7	1.1	0.9	-0.1	0.5	0.8	1.0
United States***	1.5	2.3	3.0	2.5	1.3	2.1	2.5	2.0

* refers to year ending March ** new CPI series *** eop for CPI inflation

Policy interest rates, eop

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.00	6.25	6.50	7.00	7.00	7.00	7.00	7.00
Indonesia	4.25	4.75	5.50	5.75	5.75	5.75	5.75	5.75
Malaysia	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Philippines	3.00	3.50	4.00	4.50	4.75	5.00	5.00	5.00
Singapore**	1.40	1.65	1.90	2.15	2.15	2.40	2.40	2.65
South Korea	1.50	1.50	1.50	1.50	1.50	1.75	1.75	2.00
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.50
Thailand	1.50	1.50	1.50	1.50	1.75	2.00	2.25	2.50
Vietnam***	6.25	6.25	6.25	6.25	6.50	6.50	6.75	6.75
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	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50

* 1-yr lending rate; ** 3M SOR ; *** prime rate

Exchange rates, eop

	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19	Q3 19	Q4 19
China	6.28	6.62	6.85	6.95	6.90	6.85	6.80	6.75
Hong Kong	7.85	7.85	7.85	7.85	7.84	7.83	7.82	7.81
India	65.2	68.5	72.5	73.0	73.5	74.0	74.5	75.0
Indonesia	13728	14330	15000	15050	15100	15150	15200	15250
Malaysia	3.86	4.04	4.16	4.24	4.22	4.20	4.18	4.16
Philippines	52.2	53.4	54.0	54.5	55.0	55.5	56.0	56.5
Singapore	1.31	1.36	1.38	1.42	1.41	1.40	1.39	1.38
South Korea	1064	1115	1150	1200	1190	1180	1170	1160
Thailand	31.2	33.0	33.0	34.0	33.8	33.6	33.4	33.2
Vietnam	22775	22938	23300	23350	23400	23450	23500	23550
Australia	0.77	0.74	0.70	0.68	0.69	0.70	0.71	0.72
Eurozone	1.23	1.17	1.14	1.12	1.13	1.14	1.15	1.16
Japan	106	111	112	115	114	113	112	111
United Kingdom	1.40	1.32	1.27	1.25	1.26	1.27	1.28	1.29

Australia, Eurozone and United Kingdom are direct quotes

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 68782072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist - Eurozone & India
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

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