Economics & Strategy Weekly

Weekly: Literal and metaphorical smog

Economics/Strategy/Rates/FX/Equities/Credit

DBS Group Research

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- *Human-generated smog, literal and metaphorical, is characterising the global economic and markets outlook*
- *The market is well-supplied with oil, but spill-over from Saudi drone attacks could be grave*
- *Data from China disappointed this week, suggesting more policy easing in the pipeline*
- *Despite a widely anticipated rate cut, there remains considerable uncertainty about the direction of US monetary policy*

Haze around Singapore, Middle-East, UK, and US outlook

This week brought major developments that unfortunately muddled the global economic and political outlook. But first, a few observations on climate. From our vantage point in Singapore, an unpleasant haze has enveloped the city state, with smoke from fires in nearby islands causing air pollution to rise sharply. The toxicity of carbon dioxide and carbon monoxide emission attributable to human activities (from burning of fossil fuels to setting forests and fields on fire to create clearing) is well known. Lately, scientists have been establishing vividly the far-reaching implication of such toxicity.

In particular, recent findings on the impact of airborne pollution on children are striking. According to an NBER working paper, early childhood exposure to pollution significantly impacts later life outcomes https://www.nber.org/papers/w19571. Also, a 2015 study on the impact of air pollution on school children in Barcelona shows that sustained exposure to high levels of pollution is associated with a smaller increase in cognitive development over a 12-month period among 7- to 10-year-old children.

Grown-ups suffer widespread consequences as well, ranging from lower productivity of those who work outdoors to a general decline in the quality of life. While debate over climate change continues, tackling air pollution has become a globally accepted imperative, and as China's experience over the past decade shows,

strong action can improve air quality quickly, with major positive outcomes on human health and happiness.

Moving on from one human-generated smog (literal) to another (metaphorical), the drone attacks on Saudi Arabia's oil facilities last weekend were dramatic and consequential, but it is not at all clear what they will amount to as far as global oil supply, Iran's antagonism with Saudi Arabia and US, and the state of the civil war raging in Yemen is concerned. In this note, we present some estimates on the impact of a sustained upside to oil price on key Asian economies in our coverage.

Just when it seemed like data from China were stabilising, this week's releases did not help those looking for a turnaround. The latest batch of data (industrial production, fixed asset investment, retail sales, and auto sales) reinforces our view that growth will probably weaken more this quarter and increase the likelihood of further policy easing before 2019 is over. Leading indicators showed mixed signals. Caixin manufacturing PMI increased to 50.4 in August from 49.9 previous month. But trends on the supply and demand side diverged, with rising output but falling new orders. Notably, new export orders slid deeper into contractionary territory.

Staying on with China, we remain concerned about the outlook for hard currency credit, especially given the widening of spreads in the past month or so. China's structural slowdown and a decline in profitability have induced financial stresses A coming wall of maturities for distressed credit is likely to stir rollover concerns. 2020 could thus mark High Noon for Chinese defaults, surpassing previous high. Without state support, monetary easing alone is unlikely to narrow Chinese credit spreads broadly. Click here for our detailed note.

So much was going on this week that Brexit matters took somewhat of a backseat, but lack of clarity continues to characterise the outlook. PM Boris Johnson's visit with European leaders underwhelmed, but the idea of an Irish backstop with support from Northern Ireland's Democratic Unionists Party made some progress. EU has ratcheted up pressure on PM Johnson to come with a concrete, written plan to break the ongoing deadlock by September 30. The show continues.

Finally, despite a widely anticipated rate cut, there remains considerable uncertainty about the direction of US monetary policy. The FOMC decision was characterised by an unusual degree of dissent, while various idiosyncratic factors caused striking spike in funding costs. The policy rate cut was accompanied by commentary that appeared to reflect only mild concern about the outlook, which left the market dissatisfied. We think that this week's steps to improve repo operations could be followed by a resumption of asset purchases in the coming months. As for the outlook, short of a major re-escalation in trade war, Chair Powell may find it hard to build the case for another cut this year. Read our note here.

Taimur Baig

BOJ moves closer to rate cut

We expect a 10bps rate cut at BOJ's October 31 meeting, which will take the short-term policy rate to -0.2% from -0.1% currently. The BOJ is set to "re-examine economic and price developments" at the next meeting on 31 October, when the quarterly economic outlook report is released. We see a good chance that the BOJ will trim its annual inflation forecasts, which currently stand at 0.8% for FY2019, 1.2% for FY2020 and 1.6% for FY2021, respectively. CPI inflation (core, excluding fresh food) has slipped to 0.5% YoY in Aug19 from the peak of 0.9% in Mar19. On the sequential basis, CPI growth has fallen more notably, to -0.1% 3M/3M saar from 0.8% during the same period.

The impact of a 2ppt consumption tax hike, which is scheduled for October 1, will become visible by the October BOJ meeting. The pre-tax hike rush demand has emerged – sales of big-ticket items like motor vehicles have started to pick up, registering 4.1% YoY growth in Jul19 and 6.7% in Aug19. A post-tax hike decline would be inevitable, in our view, albeit more moderate compared to during the 2014 episode of consumption tax increase.

The fallout of China-US and Japan-South Korea trade tensions will likely become more notable in 4Q. South Korea has formally removed Japan from its whitelist this month, lengthening the approval process of export shipments.

Under the current policy framework of Quantitative and Qualitative Easing (QQE) with Yield Curve Control (YCC), the BOJ is maintaining the short-term policy rate at -0.1%; the 10-year JGB yield target at ±0.2% around zero; the quantity target of JGB purchases at around JPY 80tn per annum; the pace of ETF and REIT purchases at JPY 6tn and JPY 90bn per annum, respectively. The forward guidance on monetary policy stands as following: the BOJ will continue expanding the monetary base until inflation (CPI less fresh food) exceeds 2% and stays above it in a stable manner; and maintain the extremely low levels of short- and long-term interest rates at least through around spring 2020.

Negative interest rate policy has had undesirable side effects. The JGB yield curve flattened sharply after the NIRP was introduced in January 2016 and the zero floor on interest rates was removed, aggravating the pressure on banks' profits. Market reactions were negative back then, with the yen appreciating versus the dollar and financial stocks leading the decline of the Nikkei. Drawing lessons from 2016, a mix of measures will likely be adopted this time to mitigate the unfavorable implications for the banking sector and avoid market backlash, e.g., reducing the portion of banks' reserves subject to negative deposit rates, offering negative lending rates to banks, and cutting the quantity of bond purchases to support the long-end of the yield curve.

Tieying Ma

FX: Don't fight monetary policy divergences

The monetary policy stances of central banks in Developed Markets have returned in favour of the US dollar. Barring further shocks to the global economy, the Fed's economic projections and guidance suggested that it was likely done with its mid-cycle adjustment. The Fed's most dovish counterpart is the European Central Bank who is set to resume its (open-ended) asset purchases programme in November. The Bank of Japan held monetary policy steady on September 19 but opened the door for an easing in October, the same month the VAT is scheduled to increase to 10% from 8%. The Bank of England has signalled a "dovish hold" at its meeting on September 19 now that UK inflation has fallen below its 2% target. The Reserve Bank of Australia will consider further easing, in addition to the two cuts in June-July, if consumer spending and the government tax rebates fail to offset the downside risks from global trade tensions.

Growth and inflation forecasts

		2019		2020		2021	
Indicator	by	Sep	Jun	Sep	Jun	Sep	Jun
Real GDP	Fed	**2.2**	2.1	**2.0**	2.0	**1.9**	1.8
	ECB	**1.1**	1.2	**1.2**	1.4	**1.4**	1.4
Inflation	Fed	**1.5**	1.5	**1.9**	1.9	**2.0**	2.0
	ECB	**1.2**	1.3	**1.0**	1.4	**1.5**	1.6

To be sure, the Fed's two "hawkish cuts" did not take down the US dollar this year, just as its three "dovish cuts" failed to lift the greenback in 2017. The relative growth outlook, especially the one between the US and the Eurozone, matters greatly to the USD Index (DXY) for one simple reason. The euro accounts for a whopping 57.6% of the weight in the DXY index. The Fed had kept its 2019-2020 growth forecasts firm and at/above 2% while the ECB's growth projections have edged closer to 1% from 1.5%. As for inflation, the Fed expects a pick up to 1.9% in 2020 from 1.5% this year. Conversely, the ECB expects inflation to decelerate to 1% from 1.2%. We see EURUSD headed into a lower 1.05-1.10 range and the DXY appreciating to its psychological 100 level.

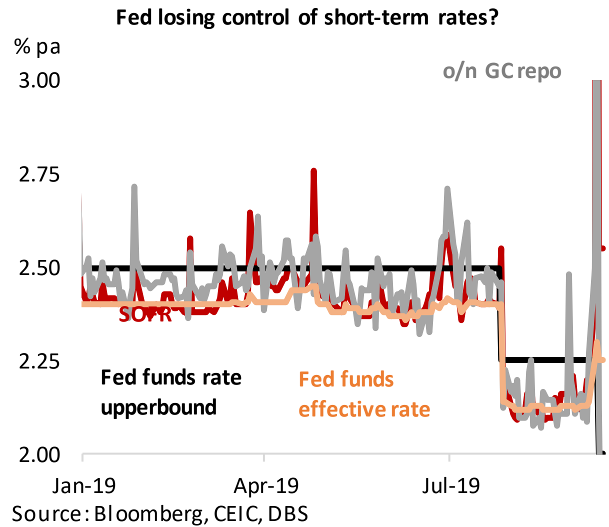
The British pound's recovery has stalled around 1.25. The major political parties in UK have become more divided on Brexit. The ruling Conservative Party led by PM Boris Johnson has not backed down on leading the UK out of the EU, with or without, a deal on October 31. The main opposition Labour Party led by Jeremy Corbyn is pushing for a second referendum. Liberal Democrat leader Jo Swinson wants to revoke Article 50 and would not back any government led by Johnson or Corbyn. With the UK parliament widely divided, the EU will only consider another Brexit delay if UK seeks a general election and sees no chance of achieving an alternative withdrawal agreement. Hence, a no-deal Brexit still cannot be ruled out, and with it the prospect for **GBPUSD to eventually fall into a lower 1.15-1.20 range.**

Philip Wee

Rates: Fed's non-committal guidance

This week, the Fed delivered another 25bps worth of cuts, taking the Fed funds rate upper bound to 2%. Markets were expecting a more dovish take from the Fed and were caught wrong footed, sending yields (especially the shorter-term ones) sharply higher when Powell emphasized that the US economy is on firm footing. Moreover, the Fed appears to be mildly complacent in addressing USD funding concerns and that may have disappointed some bond bulls.

The takeaway from the FOMC is that **further rate cuts may not be as forthcoming**. "Insurance cuts" should not amount to more than 2-3 and unless economic numbers tank or a shock hits (worsening of trade tensions), the case for aggressive cuts would not be compelling. The median dot plot for end-2019 and end-2020 now stand at 1.875% (no more cuts). However, this figure masks **the sizable dispersion in views on where policy rates should be heading** in the coming quarters. On balance, we suspect that market will maintain a dovish bias noting that external risks (global growth, trade war and hard Brexit) are still lingering. However, **a bottom in USD rates (longer-term swaps and yields) have likely already been traced in late August / early September.**



Source: Bloomberg, CEIC, DBS

The Fed addressed the USD funding squeeze but did not offer details on a more permanent solution. The IOER was reduced by 30bps (5bps more than the Fed funds rate), but this is a token move compared to the swings seen in overnight rates. At this juncture, the Fed appears to be prepared to utilize ad-hoc repo operations a lot more frequently (Friday will mark the fourth consecutive day) to handle liquidity stresses. To be sure, **the Fed hinted that balance sheet expansion will likely take place sooner rather than later. Further details may be available in October.** If announced, the amount would likely be small (USD 10bn/mth) and should not be misconstrued as quantitative easing. **We suspect that a standing repo facility is still the best way to cap unwanted spikes in overnight funding costs.**

Eugene Leow

Credit: Yields stay firm amidst a hawkish Fed cut and money market concerns

The Fed rate cut this week did not lead to a significant softening in corporate bond yields, given that the FOMC's projections came in less dovish than market pricing. The Bloomberg Barclays EM Asia credit index's average yield still trades above lows seen in early September, with the rise in Treasury yields offsetting slightly smaller spreads for IG bonds.

Renewed positivity in markets had a more significant impact on the HY credit market, and we have seen both Asian and US HY credit spreads compressing by around 10bps. **A bump in oil prices after attacks on a Saudi oil facility, accompanied by another Fed rate cut, should provide a bigger fillip for US shale credits.** US shale companies could see more relief given their heavy debt burdens, which were accumulated from sustained capital investment in the boom years.

Meanwhile, funding stresses in the USD GC repo market bear watching. While the proximate cause of recent spikes in repo rates is due to corporate tax payments and heavy Treasury issuance, a sustained tightening in money market liquidity may trigger asset unwinds, leading to wider spreads and higher premiums. The Fed has lowered its IOER rate and conducted two reverse repos to address the liquidity shortage, which **should be enough to diminish fears over liquidity for now.**

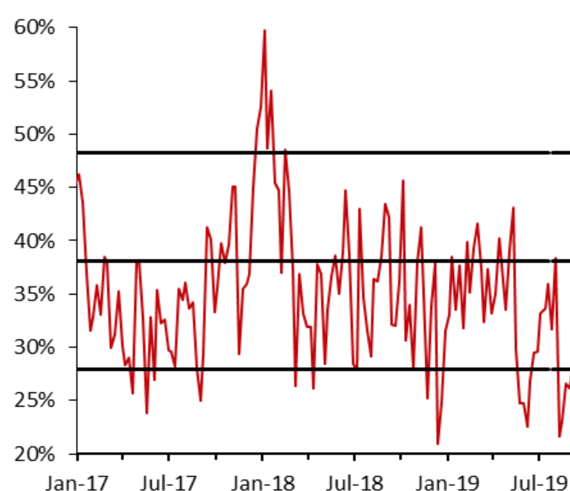
Chang Wei Liang

Equities: US Investor optimism rebounds to its highest level since late July

American individual investors' bullish sentiments continue to rebound in September since slumping in early August. We believe investor sentiments can continue to be positive following monetary easing efforts by global central banks and the thaw in US-China trade relation where talks will resume in early October. Fed's "hawkish" cut, accompanied by a stamp of confidence in the US economy by Fed Chairman Powell should continue to draw investors' confidence that a recession, which was signalled by the inverse yield curve few weeks ago, could be averted.

Meanwhile US 10-year bond yields have recovered from low, which to us, is a positive signal that excessive pessimism is unwinding. The S&P rally could broaden out to more sectors and thus add legs to the rally.

Bullish, but not overexuberant US retail investors signal upside for S&P (Investor survey — % of investors who are bullish)



Source: AAII.com – American Association of Individual Investors. Bands are average and +/- SD bands from period since 1987.

Joanne Goh

Highlights of the week:

Credit: High Noon for distressed Chinese credit

China: Weak August data calls for more loosening

India: Round four of growth support measures

Saudi drone attacks: Implication for assets

Chart of the Week: Global oil supply situation

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	6.2	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	0.5	1.1
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	3.0	3.2	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	2.8	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	5.00	5.00	5.00	5.00	5.00
Indonesia	6.00	6.00	5.25	5.00	5.00	5.00	5.00	5.00
Malaysia	3.25	3.00	3.00	2.75	2.75	2.75	2.75	2.75
Philippines	4.75	4.50	4.25	4.00	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	1.25	1.25	1.25	1.25	1.25
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	-0.20	-0.20	-0.20	-0.20	-0.20
United States	2.50	2.50	2.00	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).

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