Economics & Strategy Weekly

Weekly: Recession worries and declining rates

Economics/Strategy/Rates/FX/Equities/Credit

DBS Group Research

October 04, 2019

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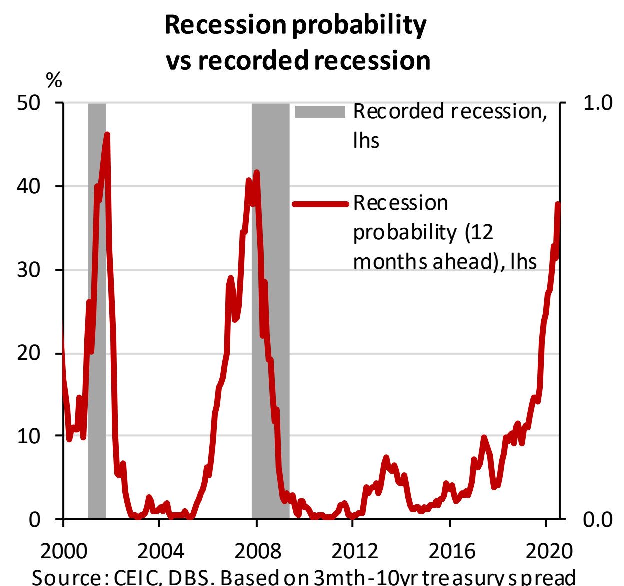
- *Event risks keep mounting both on the geopolitical and economic fronts.*
- *Sharp decline in government bond rates and rebound in gold price highlight the deepening sense of risk aversion.*
- *One looming risk is if the ongoing contraction in manufacturing activity would spill over into services and begin to weigh down employment, income, and consumption.*
- *Another risk if the US economy is about to follow the rest of the world on a much weaker growth path*

October begins with mounting stress

Brexit, impeachment, trade war, Hong Kong, Iran, manufacturing recession, investment uncertainties, negative rates, tech valuation, there is no shortage of event risks in the horizon, making investors understandably listless. Flight to safety is back on, with government bonds and gold rallying.

There are two core concerns: first, globally, if the ongoing contraction in manufacturing activity would spill over into services and begin to weigh down employment, income, and consumption. Second, if the US economy, which has been steady at around 2% real GDP growth, in contrast to slowing momentum in EU, China, and most key emerging markets, is about to follow suit on a much weaker path. Fixed income markets have been clearly signalling that US slowdown, if not an outright recession, is around the corner. The poor reading from September ISM have compounded matters.

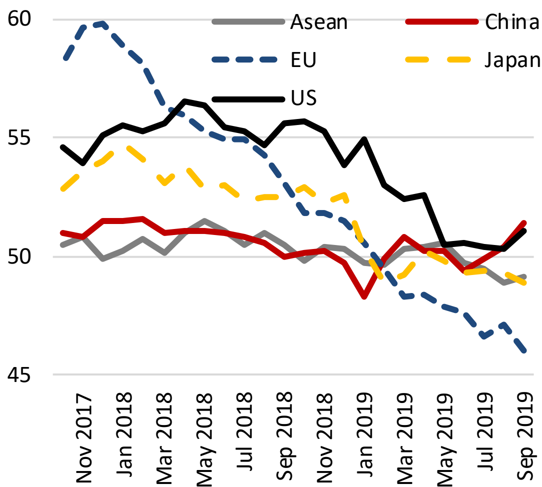
Recession probability vs recorded recession



Source: CEIC, DBS. Based on 3mth-10yr treasury spread

Darkening cloud over US manufacturing is understandable, especially as auto and machinery production has been poor. But US manufacturing PMI, along with China's, is by no means in dire territory. Far worse are the readings from EU, Japan, and Asean.

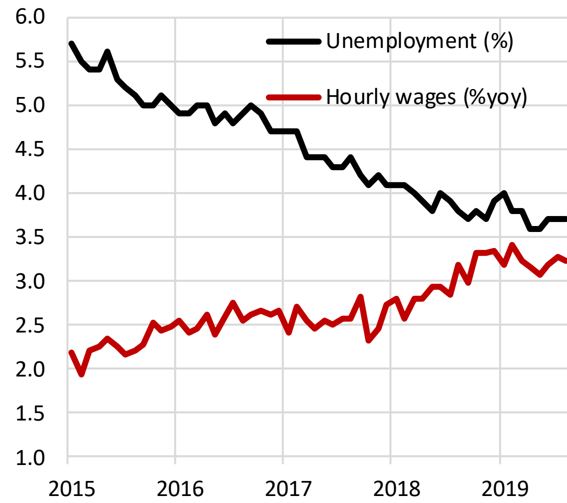
Markit manufacturing PMIs



Bloomberg, DBS

There is a reason that US consumers are holding up despite the political noise, trade tensions, and corporate earnings worries, they are employed, and their wages are rising. As long as that trend persists, consumption will likely hold up, in our view.

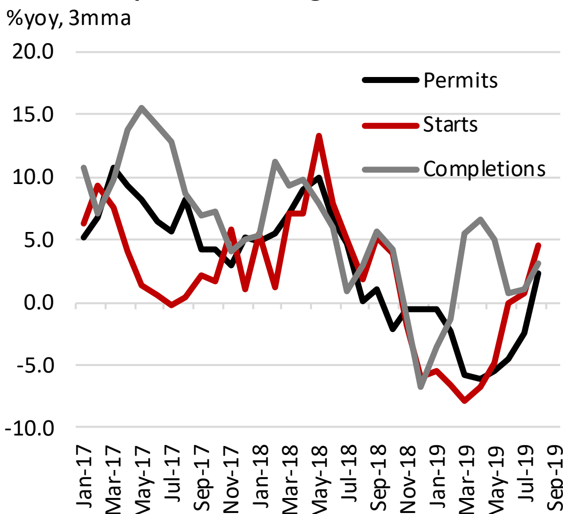
US labour market



Source: CEIC, DBS

We still don't see material spill-over from global manufacturing to the US. The housing market, for instance, has benefitted from lower rates this year, rebounding across a wide range of indicators, including residential permits, construction starts and completions.

US private housing construction



Source: CEIC, DBS

But it is just a matter of time before employment in manufacturing begins to suffer in the face of weakening global demand. It may well be that the US service sector holds up for a while; after all, even after the overnight ISM non-manufacturing disappointment, the reading remains firmly in expansionary territory. But short of an easing of trade tensions, reduction in political noise out of Washington, and bottoming of external demand, the US can remain decoupled from the rest of the world for only so long. Fed policy makers will have to take into account such risks in the months ahead. While our formal call remains for no further rate cuts this year, the chance of the Fed moving at least one more time this year is clearly rising.

Taimur Baig

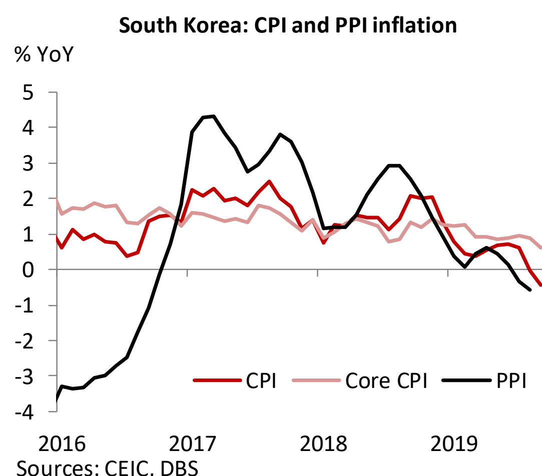
South Korea: No deflation, but low inflation is here to stay

Inflation data out from South Korea this week caught investors' attention. Headline CPI posted -0.4% YoY in September, a further slide compared to 0% in August, and the first negative reading over more than half a century.

This "deflation" phenomenon should be transitory. The year-ago comparison base for food prices was exceptionally high in September, due to weather abnormality and supply shocks. But the high base effect will dissipate from December onwards. Meanwhile, the impact of the recent outbreak of African swine fever on meat prices has not been reflected in September survey yet. The impact is likely to surface this month.

Low inflation is here to stay, however. Consumers' inflation expectations for the next 12 months have fallen to 1.8% in September, the lowest since the data was first released in 2002. PPI has also stayed on a downtrend, suggesting weak pricing power among the upstream producers.

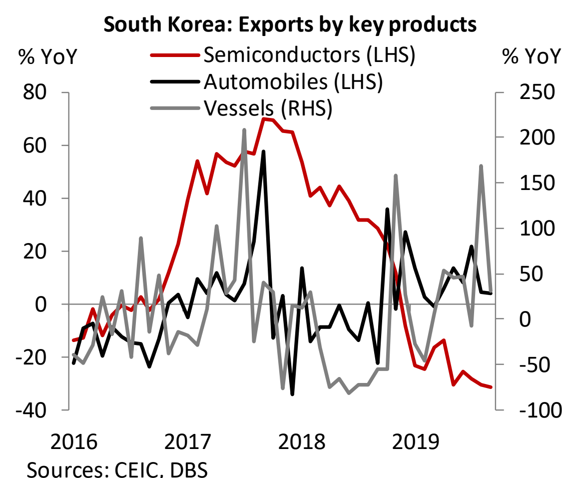
We expect CPI to stay in the negative territory for three months and inch upward to about 1% from December onwards.



Sources: CEIC, DBS

Separately, this week's data also showed that exports continued to contract sharply by -11.7% YoY in September, the tenth consecutive month of decline and a similar pace as in August (-13.8%). Exports to China fell the most by -21.8%, while semiconductor shipments plunged -31.5%. This probably reflected the fallout of the recent, further tariff hikes between China and the US, as well as the administrative export controls between Japan and South Korea.

The only relief is that private consumption made a comeback. Retail sales reported a notable gain in August (3.9% MoM sa), while consumer confidence rebounded in September (4.4ppt). But this could be attributed to the temporary increase in holiday demand associated with the Chuseok Festival.



Sources: CEIC, DBS

Sluggish inflation and trade data point to the chance of a further rate cut by the Bank of Korea (BOK). **We expect the BOK to lower the benchmark repo rate to 1.25% from 1.50% at the October 16 meeting, along with a downgrade in its 2019 GDP growth and inflation forecasts.**

Ma Tieying

FX: Recession risks favour USD

Stocks and bond yields have fallen across the globe on increased recession worries. Although the US has not been spared, **the greenback has remained resilient relative to its more vulnerable counterparts**. Negative growth risks and negative rates have weighed against the European currencies including the Swiss franc. Vulnerable to a global recession, commodity-led currencies have been avoided by investors.

The Chinese yuan may resume its depreciation when China returns from holiday next week. Optimism has faded for a deal at the China-US trade talks due to restart on October 10. Worse, the US has threatened to turn its trade war with China into an investment war. Consensus has turned more pessimistic on China's growth, now seen falling below 6% in 2020.

The landscape has deteriorated for the euro and the British pound. A potential US-EU tariff war has joined a weak German economy and hard Brexit risks in tipping the EU economy closer towards recession. Acknowledging the inadequacy of its stimulus measures, the European Central Bank has backed France's call for a fiscal union to bolster the Eurozone. The Bank of England has also leaned towards a rate cut. Even if a no-deal Brexit is avoided, BOE reckoned that Brexit uncertainty will stay persistently high and weigh on the UK economy and inflation.

Against the weak global backdrop, **Singapore will temper its appreciating SGD policy** before mid-October. The rise in USDSGD, however, will be driven by the weak exchange rates of its major trading partners.

Philip Wee

Rates: Curve steepening to play growth fears

Thursday's ISM non-manufacturing miss (actual: 52.6, consensus: 55.0) stirred further fears that a US slowdown is already underway. Market participants were already on alert after ISM manufacturing numbers nudged to a decade of low of 47.8 underscoring the global manufacturing slump. However, **it appears that manufacturing weakness has spilt over the US services sector**, suggesting that US growth may be closer to stall speed. With US resilience being questioned, the global growth narrative has turned more pessimistic.

The US Treasuries curve has bull steepened for two straight sessions with the 2Y/10Y spread touching 14bps (from 4bps on Monday) as rate cut bets intensified. 2Y yields pushed to a new fresh low for the yield as the market bets that the Fed will cut another two times by the end of 2019. Comparatively, 10Y yields are still hovering above 1.50% (some 10bps above its recent low). While betting that the Fed will underwrite the slowing economy makes some sense, we think that investors are becoming uncomfortable with duration risks. Notably, inflation expectations (as measured by the 10Y breakeven) are now below 1.5%. Meanwhile, we suspect that the fiscal drumbeat will turn louder in 2020 if the slowdown persists and could cause underperformance for long-end USD rates. **We see further steepening in the coming months.**

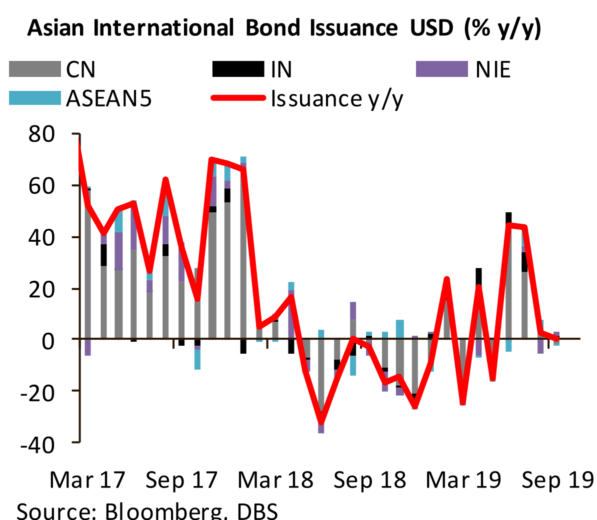
Eugene Leow

Credit: Tempered sentiment amidst rising risk aversion

With mainland China out for National Day holidays this week, EM Asian credit market activity has tapered off. **Market sentiment has been tempered by a bout of risk aversion**, with a very soft US ISM stirring fears of a more pronounced US slowdown ahead.

Negativity over US growth has in turn driven a sell-off in US high yield credit. The average yield for Bloomberg-Barclays US Corp HY index has risen to 5.90%, the highest since mid-August. US IG credits have proven much more resilient though, with spread widening being offset by sharply lower UST yields.

The media has touted **a pick-up in Asian international bond issuance for Sep**, supported by a wave of Chinese issuance prior to the Oct holidays. This may be seasonal in nature, as Chinese issuance (in USD terms) is still lower compared to year-ago levels. Other Asian issuers are also not likely to bolster, with Indian banks struggling with liquidity stresses while Korea now confronts deflation risks. Better growth visibility will be anxiously awaited by all.



Chang Wei Liang

Highlights of the week:

India: How many policy rate cuts are left?

China chartbook: 70th Anniversary of the People's Republic of China

Chart of the week: China-US trade deficit

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	5.7	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	3.75	3.50	3.50	3.50	3.50
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	6.00	6.00	5.75	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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