Economics & Strategy Weekly

Weekly: Watch out, inflation has bottomed

Economics/Strategy/Rates/FX/Credit

DBS Group Research

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Taimur Baig
Chief Economist
taimurbaig@dbs.com

Chang Wei Liang
Macro Strategist (FX and Credit)
weiliangchang@dbs.com

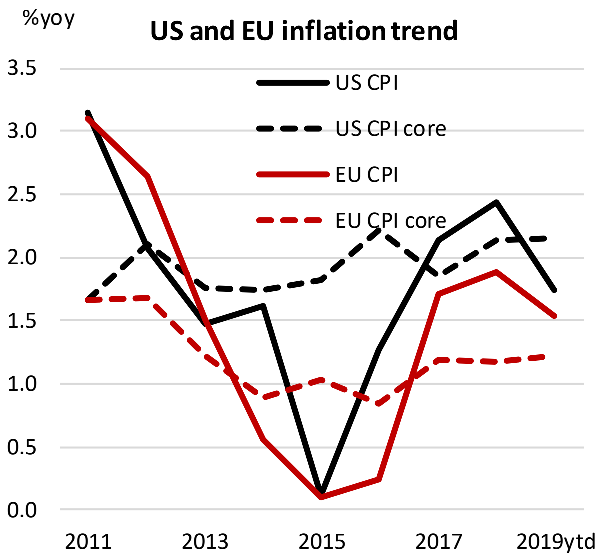
Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *Amid flattening yield curves, recession worries, negative policy rates, and geopolitical tensions, the trough in global inflation dynamic has been largely ignored. Is such complacency justified?*
- *Globally, food and metals have clearly bottomed. Energy prices are about to join the fray.*
- *Inflation is unlikely to spike in the coming year but won't be a support for further decline in interest rates.*
- *A resulting steepening of curves may cause spreads to widen, but also be a healthy development in diffusing deflation fears.*

Inflation is benign, but not declining any longer

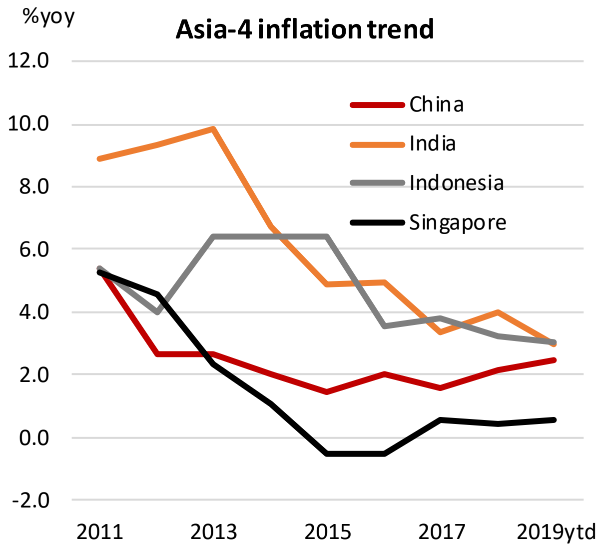
There are many things on investors' minds these days, but inflation is not one of them. At a time when global growth is slowing, geopolitical tensions are causing risk aversion to rise, supply side pressure is not apparent. Inflation expectations are low, neither central banks nor financial market participants are showing any worries about the inflation outlook, as seen by the monetary policy stance and behaviour of interest rates worldwide.

But is such complacency warranted, when one looks at the inflation data from both developed and developing markets? First, tracking US and Eurozone inflation outturn of recent years, headline inflation is seen to have rebounded decisively from 2015 onward, and has only dipped marginally this year. More strikingly, core inflation appears low but on a clear uptrend in both economies.



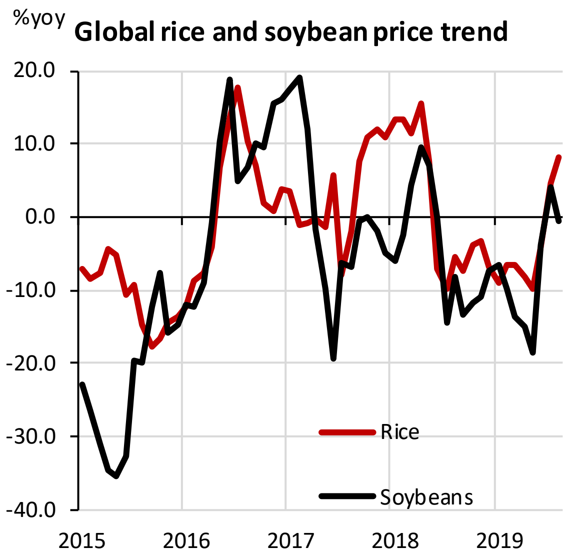
Sources: CEIC, DBS

Second, in Asia, looking at China, India, Indonesia, and Singapore, four bellwether economies, signs are clear that inflation is low but bottoming. Helped by constructive monetary policy stance, no major fiscal slippage, muted demand, and benign food and energy prices, these economies have experienced a prolonged bout of mild inflation since 2015. But looking ahead, we are doubtful that further disinflation is likely. If anything, base effect dynamic suggest that inflation has bottomed out in the region.



Sources: CEIC, DBS

Ignoring domestic idiosyncratic factors like pork price in China and onion price in India, we consider the global commodity price dynamic along a range of important items. Across rice, soybean, as well as base and precious metals, there are no major technical or fundamental reasons for further disinflation. Energy price inflation is also on course to bottom out in the coming months. Unless demand from China undergoes a major downturn, we think that the weakest phase of inflation is behind us. This could also cause rates to bottom, curves to steepen, and spreads to widen. Watch out.



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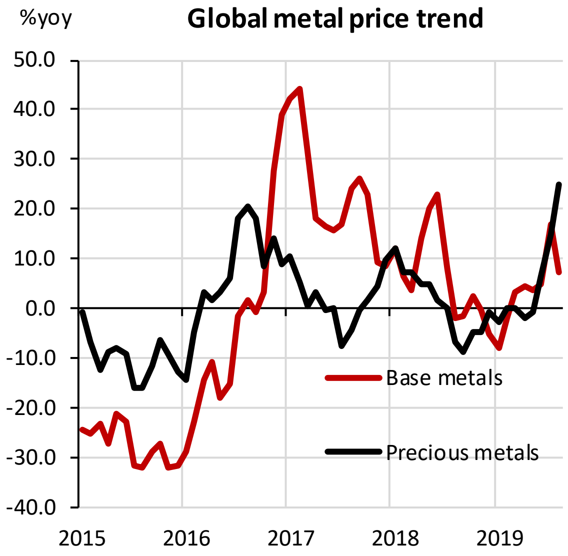

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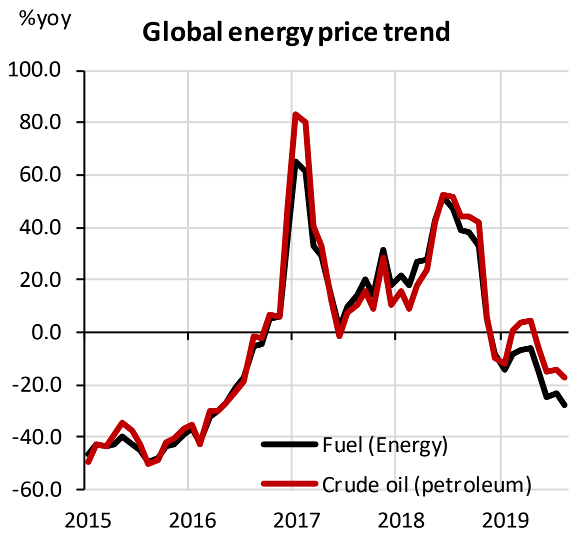


Sourced: CEIC, DBS

Taimur Baig

FX: Hope for the best, prepare for the worst

As we anticipated, investors got a reality check on their excessively optimistic expectations for a China-US trade deal and a Brexit deal.

Last week's China-US trade talks have yet to ratify the "Phase 1" deal agreed in Washington. China wants the US to suspend, apart from the tariffs originally scheduled to hit Chinese goods on October 15, the additional tariffs set for December 15. Separately, the US Treasury Department has yet to decide how to treat China in its currency report normally released around mid-October. **The mid-rate for USDCNY has flattened around 7.07 over the past month.** Beijing has also criticized the US Lower House for passing the Hong Kong Human Rights and Democracy Act, bringing it closer to becoming law. These are some of the issues that may prevent Chinese President Xi Jinping and US President Trump from signing the deal at the APEC Summit on November 16-17.

Similarly, **the Brexit deal that Prime Minister Boris Johnson struck with the EU is not secure yet.** Considered worse than Mrs Theresa May's withdrawal agreement, Mr Johnson's "great new deal" was not supported by its crucial ally, the Democratic Unionist Party (DUP) and rejected by the opposition parties. Not surprisingly, **the British pound was quick to give back most of the sharp gains from the deal's announcement**.

Without a Commons vote to support the deal or the UK leaving the EU without one, Mr Johnson will be required, under the Benn Act, to request by October 19, the EU for an extension of Article 50 to January 31, 2020.

Unfortunately, **there is no guarantee that Brussels would grant a Brexit delay.** Now that a deal has been brokered, EU President Jean-Claude Juncker has ruled out a further delay. The authority, however, lies with the EU 27 leaders to grant the extension. The EU had previously signalled preference for a longer extension to June 2020 for the UK to hold new elections or a second Brexit referendum. **Nonetheless, the risk of a no-deal Brexit on October 31 still cannot be totally ruled out.** After its surge from 1.22 to 1.30 in six trading sessions, GBPUSD is vulnerable to profit-taking risks before tomorrow's crucial Commons vote.

Over the past fortnight, one trend was clear. **Investors and speculators have been hoping for the best even as governments and policymakers prepare for the worst.** The IMF downgraded its global economic outlook a third time this year, a stark reminder that the outlook remains precarious with doubts that the synchronized slowdown will transit into a broad-based recovery next year.

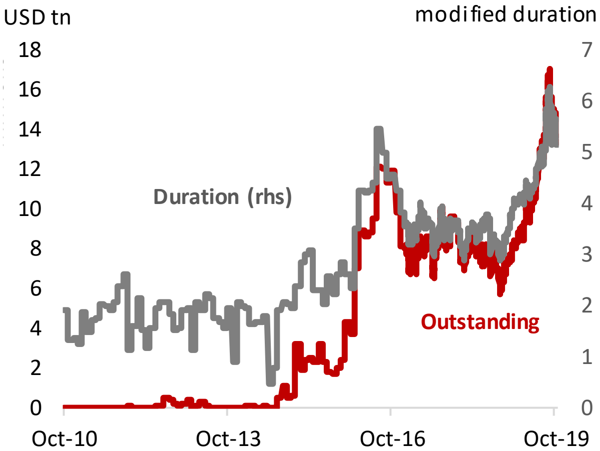
For Emerging Asia, **the IMF has lowered China's growth to below 6% for 2020 and the Asean-5 to below 5%** for 2019 and 2020. The region's weakness was also underscored by the prospects of Hong Kong sinking into recession. In Singapore, the central bank has kept the door open for more easing if growth and inflation deteriorated significantly. Hence, the SGD NEER is still considered uncharacteristically strong near the upper limit of its policy band.

Philip Wee

Rates: Neutral on G3 rates

The amount of negative yielding debt has fallen to USD 13tn, down from a peak of USD 17tn in late August. However, this has not garnered much attention as market participants focused on China-US trade tensions and Brexit. We stand by our view that long-term USD rates (and likely G3 rates) may have already bottomed. There have been increasing signs of pushback from major central banks towards lower rates. In particular, the Bank of Japan (BOJ) may be worried about an overly flat curve negatively impacting the financial system. In addition, the markets may have to contend with ultra-long US Treasury issuances and the potential for more fiscal spending from Germany as growth stalls.

Negative yielding debt fell USD 4tn from peak



Source: Bloomberg, CEIC, DBS

We are neutral on G3 yields at current levels. Short-term volatility on trade tensions and Brexit is inevitable. Optimism on both fronts have lifted yields, but we doubt that yields could go much higher in the absence of better economic data or looser fiscal policies.

Eugene Leow

Credit: Sentiment bump on Phase 1 Deal

While existing US tariffs have not been rolled back, **markets are clearly relieved at the announcement of the US-China Phase 1 trade deal.** This signifies a de-escalation in recent trade rhetoric, as well as new US flexibility over splitting issues into multiple phases, rather than negotiating all issues in totality.

Improved market sentiment has triggered a compression of Emerging Asian corporate spreads, notwithstanding doubts over future execution of the agreement. The Bloomberg-Barclays EM Asia index has seen its average OAS narrowing by 5bps, with the HY sub-index registering a more substantive 16bps decline.

Even if US-China trade tensions are to ease, broader economic weakness could still pose headwinds to Asian credit. China's growth has slipped further towards 6% (y/y) in Q3, while the country's PPI has also fallen deeper into deflation levels. Both developments imply higher pressures on Chinese industrial profitability, which could induce financial stresses for firms who are already overly indebted.

The recently released IMF Global Financial Stability Report has flagged elevated global corporate debt burden as a key risk. The Fund pointed out that up to 40% of total corporate debt in 8 major economies could be at risk, in the scenario of a slowdown that is just half as severe as the global financial crisis. **Without a bottoming in global activity, credit risks could loom even if there is diminished negativity on US-China trade relations.**

Chang Wei Liang

Highlights of the week:

[Indonesia: Look beyond the deficit]
[South Korea: Quite possibly the last rate cut this year]
[China: Trade talks surprise but not trade data]
[Singapore averts a technical recession despite weak growth]
[Chart of the Week: Asia's policy rates versus the Fed]
[Malaysia budget 2020: Walking the tight rope]

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	4.6	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	0.6	1.4	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	1.0	1.1	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	7.15	7.20	7.15	7.10	7.05	7.00
USD/HKD	7.85	7.81	7.84	7.85	7.85	7.84	7.84	7.83
USD/INR	69.2	69.0	70.9	71.5	72.0	72.5	73.5	74.0
USD/IDR	14243	14126	14195	14500	14550	14600	14650	14700
USD/MYR	4.08	4.13	4.19	4.25	4.24	4.23	4.22	4.21
USD/PHP	52.6	51.3	51.8	53.6	53.9	54.2	54.5	54.7
USD/SGD	1.36	1.35	1.38	1.42	1.41	1.41	1.40	1.40
USD/KRW	1135	1155	1196	1250	1240	1230	1220	1210
USD/THB	31.7	31.0	30.6	32.0	31.8	31.6	31.4	31.2
USD/VND	23189	23301	23203	23220	23250	23270	23300	23330
AUD/USD	0.71	0.70	0.68	0.64	0.65	0.65	0.66	0.66
EUR/USD	1.12	1.14	1.09	1.08	1.09	1.09	1.10	1.10
USD/JPY	111	108	108	109	109	108	108	107
GBP/USD	1.30	1.27	1.23	1.16	1.17	1.18	1.19	1.20

Australia, Eurozone and United Kingdom are direct quotes

Group Research

Economics & Macro Strategy

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

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

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

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

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

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

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

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

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

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

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

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