Economics & Strategy Weekly

Weekly: Inflation not quite innocuous

Economics/Strategy/Rates/FX/Equities

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- *Markets are by and large looking through the pick-up in food price inflation in China and India*
- *Worldwide, prices of food, energy, and metals remain mostly subdued*
- *Trade war, strong labour market, continued QE, and climate change could however challenge the low inflation narrative*
- *Weak demand out of China and diminishing confidence about the outlook may well dampen some of the likely inflation drivers.*

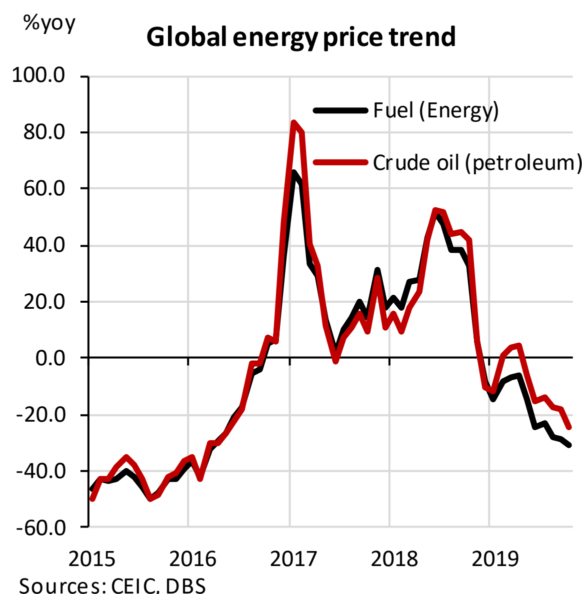
Inflation's death is exaggerated

Narratives out of China and India notwithstanding, global markets are ignoring inflation risks in general. While long-term US inflation expectations (derived from the 5-year, 5-year forward rate) have nudged up to 1.8% in recent months, they are still very low by historical comparison. Market-based inflation expectation indicators are even more subdued for EU and Japan.

But as far as markers for inflation are concerned, there are a few. A strong labour market and strong wage growth, characteristics of the US economy in recent years, ought to translate into a pick-up in inflation. Trade war related tariffs should also push up some product prices. Frequent natural disaster-led shocks to agriculture harvests should also lead to food price (and food price expectations) to nudge up. Finally, the sharp rise in public sector borrowing and de facto central bank monetisation of debt, in theory, should be raising inflation expectations.

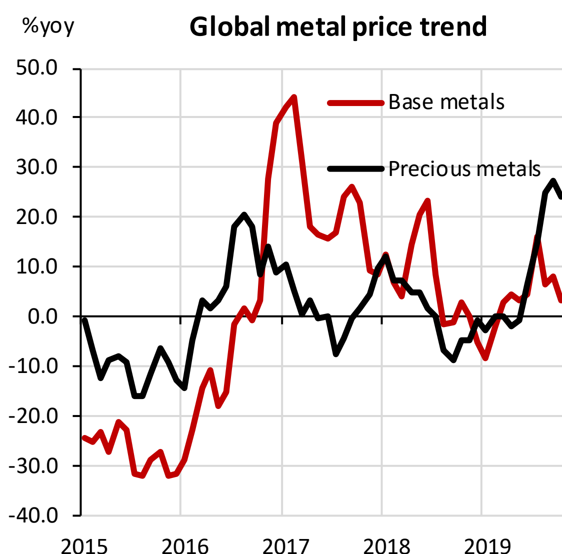
But all of this is taking place when there is growing uncertainty and diminishing confidence about the outlook, reduced pricing power among producers (as e-commerce has increased competition), subdued demand in China (which, for many products, is the largest consumer), structurally shifting energy demand, and ample inventories. Against this backdrop, some of the usual drivers of inflation are understandably getting dampened.

Examining the evolution of a variety of prices this year (with data available through October 2019), we see some sources of upside risk, although admittedly nothing to get alarmed about yet. For instance, after a sharp rally, gold prices have begun easing as flight to safety concerns have ebbed. As for base metals, very little upside is seen as infrastructure spending and manufacturing worldwide has not taken off this year, especially in China. Looking at stronger fiscal stimulus measures in 2020, along with a likely recovery in electronics manufacturing, we expect a modest rise in metals prices.



Sources: CEIC, DBS

Note: Fuel index includes crude oil, natural gas, coal

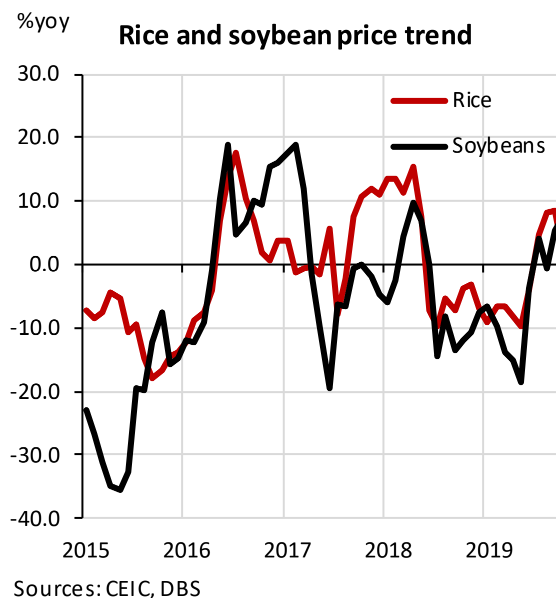


Sources: CEIC, DBS

Note: Base metals index includes aluminium, copper, iron ore, nickel. Precious metals index includes gold, silver, platinum.

On energy, despite plans by OPEC to cut supply and lingering tensions in the Persian Gulf, prices have been lacklustre this year. Short of a major conflagration in the Middle East, we expect oil prices to remain flat. Sustained production growth in US shale oil and other non-OPEC sources will continue to act as a major balancing factor in the energy sector, in our view.

China has seen soaring pork prices this year, owing to major cutback in pig supply from disease. India has seen headline inflation firm up on the back of a spike in onion prices. But beyond these idiosyncratic factors, food inflation is only mildly recovering after a sharp contraction in 2018/19. We will however remain worried about the rising frequency of natural disasters and climate change related developments that could affect global agriculture production in the coming years.



Sources: CEIC, DBS

Taimur Baig

FX: FOMC, UK election and a mini trade deal "deadline"

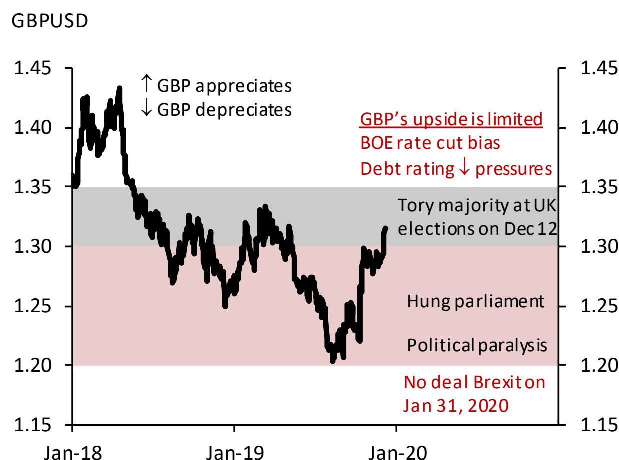
Sentiment for the USD has been dented by downside surprises in recent US data. China-US trade deal uncertainties have renewed Fed cut expectations. Still, these developments are not enough to prevent the Fed from standing pat at its FOMC meeting on December 11. After its third rate cut on October 30, the Fed signaled that it may have completed its mid-adjustment cycle. The Fed's Summary of Economic Projections should affirm its rate pause stance on a growth outlook of around 2% in 2020.

Fed's Summary of Economic Projections

Variable	FOMC in:	2019	2020	2021	2022	LT
GDP growth	**Sep**	**2.2**	**2.0**	**1.9**	**1.8**	**1.9**
% change	Jun	2.1	2.0	1.8	...	1.9
	Mar	2.1	1.9	1.8	...	1.9
PCE inflation	**Sep**	**1.5**	**1.9**	**2.0**	**2.0**	**2.0**
% change	Jun	1.5	1.9	2.0	...	2.0
	Mar	1.8	2.0	2.0		5.0
Unemployment	**Sep**	**3.7**	**3.7**	**3.8**	**3.9**	**4.2**
rate, %	Jun	3.6	3.7	3.8	...	4.2
	Mar	3.7	3.8	3.9	...	4.3
Fed Funds Rate	**Sep**	**1.9**	**1.9**	**2.1**	**2.4**	**2.5**
% pa	Jun	2.4	2.1	2.4	...	2.5
	Mar	2.4	2.6	2.6	...	2.8

Election fever has gripped the British pound but the UK election on December 12 could end up as a "buy the rumour, sell the fact" event. GBPUSD's rise above 1.30 has been triggered by a YouGov poll for a Tory majority last week. Unfortunately, polls have proven unreliable at the Brexit referendum in 2016 and the last snap election in 2017. The risk of a hung parliament cannot be totally discounted, an outcome that would pummel GBPUSD to 1.20-1.25. Even if a Tory majority happens, GBPUSD will struggle to rise above 1.35. Apart from hard trade negotiations with the EU in a shortened Brexit transition, the UK is at risk to a weak economy in need monetary/fiscal support and potential fiscal slippages that undermine debt ratings.

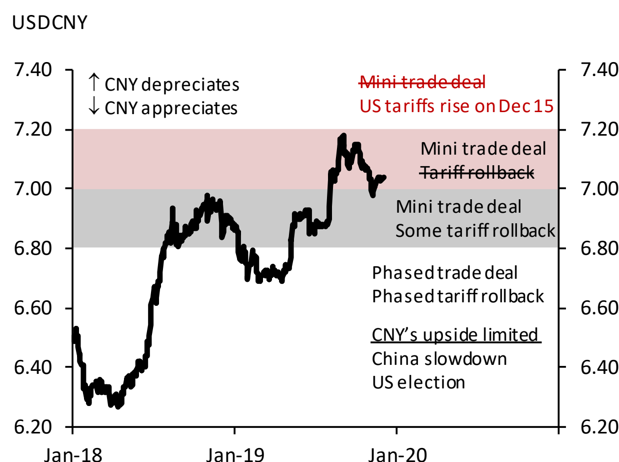
British pound is not out of the woods



Sources: DBS Research, Bloomberg data

The Chinese yuan has resumed its depreciation past 7.00 ahead of December 15, the day US tariffs are due to hit Chinese goods without a Phase 1 trade deal. China's insistence to include a rollback of existing US tariffs remain a redline. Still, the market has not totally abandoned hope for a trade deal to extend the trade truce into next year's US presidential election. A trade deal, if it comes, should keep USDCNY within 7.00-7.20 without tariff rollbacks or into a lower 6.80-7.00 range with some rollbacks. The worst-case scenario of no deal and higher US tariffs should lead USDCNY towards 7.20 again.

Chinese yuan vs possible trade deal outcomes



Sources: DBS Research, Bloomberg data

Philip Wee

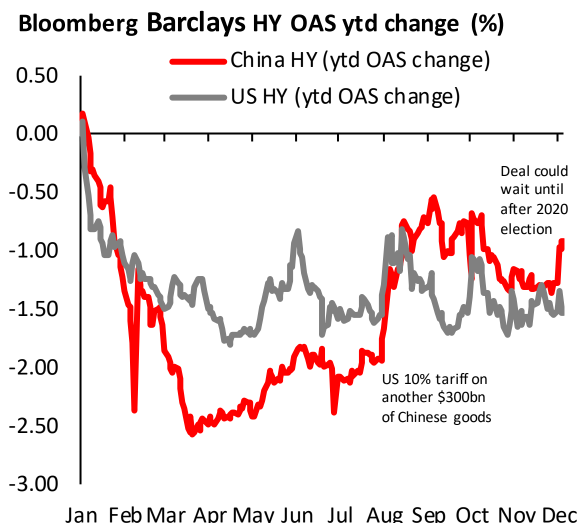
Rates: Lingering trade war risks

The trade war continues to be the main event that market participants are watching. Looking at USDCNY and US yield levels, the market is pricing in a better than even chance of a phase 1 deal that involved token tariff rollbacks. However, market participants are jittery. 10Y US yields temporarily dipped below 1.70% when Trump's comments (made on Tuesday) were interpreted out of context. Clarifications that the trade talks were still on track brought yields closer to 1.80%. While the base case calls for a phase 1 deal to be signed, the market has to factor in the possibility of a May repeat (when a widely expected deal was called off).

If a deal is not struck, another round of tariffs on Chinese goods could be in place on December 15. Moreover, the prospect of another year of uncertainties could weigh on investments, posing downside risks to US growth, **opening up the possibility of further Fed easing around mid-2020.** Regardless of trade war noise, **we think that steepening in US and DM curves remain the most likely scenario over the coming quarters.** Our base case calls for bear steepening as fiscal policies get loosened. A global cyclical recovery and a Fed hold would also facilitate higher long-term USD rates. However, if prolonged negative sentiment hurts growth, bull steepening could well take place as the Fed gets nudged to cut again.

Eugene Leow

Credit: Trade pessimism strikes back



Source: Bloomberg, DBS

Trump has lived up to his reputed unpredictability this week, **surprising markets by saying that he might prefer a China trade deal after the 2020 election.** We have been flagging trade optimism/pessimism as a key driver of Chinese high yield spreads, and so it was no surprise so see these spreads widening (+36bps) this week as trade risks flare again.

The Chinese corporate bond market was also hit by news that **a university-linked conglomerate has missed repayments on a CNY2bn onshore bond.** Offshore USD bonds linked to the conglomerate consequently fell by almost 40% to trade near 40c on the dollar. Investors certainly rue the fact that state support has not been forthcoming even for such a prestigious state-linked company.

RBI Governor Das stated post the Dec 5 MPC meeting that **the Bank won't hesitate to prevent the collapse of any large NBFCs**. This should hopefully reassure bank credit to NBFCs, supporting a normalization of credit conditions.

Chang Wei Liang

Highlights of the week:

- DBS 2020 Outlook: Beyond Economics
- Macro Insights Video: Beyond Economics

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2018	**2019f**	**2020f**	**2021f**	**2018**	**2019f**	**2020f**	**2021f**
China	6.6	6.1	5.8	5.6	2.1	2.6	2.3	2.5
Hong Kong	3.0	-1.7	1.5	1.5	2.4	2.7	2.5	2.5
India	7.4	5.0	5.8	6.4	4.0	3.5	4.2	4.5
*India (FY basis)**	*7.1*	*6.8*	*5.0*	*5.8*	*3.6*	*3.4*	*3.9*	*4.2*
Indonesia	5.2	5.0	5.0	5.1	3.2	3.1	3.4	3.2
Malaysia	4.7	4.5	4.6	4.6	1.0	0.9	1.6	1.8
Philippines**	6.2	5.9	6.3	6.3	5.2	2.8	3.5	3.3
Singapore	3.1	0.6	1.4	1.8	0.4	0.6	1.1	1.5
South Korea	2.7	2.1	2.4	2.3	1.5	0.5	1.5	1.3
Taiwan	2.7	2.3	2.0	2.2	1.3	0.7	1.0	1.1
Thailand	4.1	2.5	3.0	3.2	1.1	0.8	1.2	1.3
Vietnam	7.1	6.9	6.8	6.7	3.5	2.5	2.9	3.0
Eurozone	1.9	1.2	1.3	1.5	1.8	1.2	1.2	1.3
Japan	0.8	0.7	0.5	0.9	1.0	0.5	0.7	0.6
United States***	2.9	2.2	1.9	1.8	2.0	1.7	1.7	2.0

* refers to year ending March i.e. 2020 represents FY20 - year ending March 2020 ** new CPI series *** eop for CPI inflation

	Policy interest rates, eop							
	1Q20	**2Q20**	**3Q20**	**4Q20**	**1Q21**	**2Q21**	**3Q21**	**4Q21**
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	4.90	4.90	4.90	4.90	4.90	4.90	4.90	4.90
Indonesia	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Malaysia	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Singapore**	1.60	1.60	1.60	1.60	1.60	1.60	1.60	1.60
South Korea	1.25	1.25	1.25	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	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Vietnam***	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20	-0.20
United States	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75

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

	Exchange rates, eop							
	Q1 20	**Q2 20**	**Q3 20**	**Q4 20**	**Q1 21**	**Q2 21**	**Q3 21**	**Q4 21**
USD/CNY	7.20	7.15	7.10	7.05	7.00	6.95	6.90	6.85
USD/HKD	7.85	7.84	7.84	7.83	7.82	7.81	7.80	7.80
USD/INR	72.0	72.5	73.5	74.0	73.5	73.0	72.5	72.0
USD/IDR	14200	14300	14400	14500	14450	14400	14350	14300
USD/MYR	4.20	4.18	4.16	4.14	4.13	4.12	4.11	4.10
USD/PHP	52.0	51.5	51.0	50.5	50.4	50.3	50.2	50.1
USD/SGD	1.40	1.39	1.38	1.37	1.36	1.36	1.35	1.35
USD/KRW	1180	1175	1170	1165	1160	1155	1150	1145
USD/THB	31.0	30.8	30.6	30.4	30.3	30.2	30.1	30.0
USD/VND	23300	23300	23300	23300	23300	23300	23300	23300
AUD/USD	0.64	0.65	0.66	0.67	0.68	0.69	0.70	0.71
EUR/USD	1.08	1.09	1.10	1.11	1.12	1.13	1.14	1.15
USD/JPY	110	109	107	106	105	105	104	104
GBP/USD	1.20	1.21	1.22	1.23	1.24	1.25	1.26	1.27

Australia, Eurozone and United Kingdom are direct quotes

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