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DBS

Macro Insights Weekly

Wars, high rates, asset prices

Group Research

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- *The economic horizon is clouded by wars and ever rising rates. Asset markets have held up remarkably well, but we worry that risks are insufficiently priced.*
- *The key concern is the loss of lives and societal scars left by wars.*
- *There are broader consequences as well for regional stability and superpower relations.*
- *We are not particularly concerned about the middle-east situation causing an oil price spike.*
- *Beyond oil, the global economy is already dealing with a major shock—interest rates.*
- *The impact of higher rates has been remarkably muted so far, but we don't think that would last.*

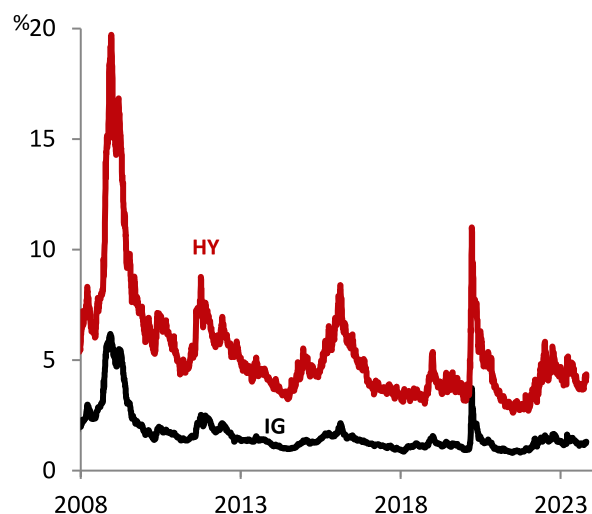
Key data release and events this week:

- *ECB is expected to keep rates on hold.*
- *Singapore's headline inflation rate is expected to stay steady at 4.1% YoY in Sep.*
- *South Korea's GDP growth is expected to rise slightly on a YoY basis, reaching 1.1% in 3Q.*

Chart of the Week: Uncomfortably calm credit

US 10-yr treasury yield has risen by more than 100 bps ytd, tightening monetary conditions and raising the cost of capital considerably. And yet, the US corporate credit market, both investment grade and high yield, has been remarkably calm, with spreads not far from historic lows. Recognising that both leverage and earnings of US corporates are largely sound and market liquidity is ample, we still worry that the prevailing calm is unsustainable. Rising cost of capital is bound to hurt, probably soon.

Credit Spreads - US Corporate



Source: Bloomberg, DBS

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Commentary: Wars, high rates, asset prices

It's been a year and a half and counting with the conflict in Ukraine, and now the world has another raging conflict around Israel/Gaza/West Bank. The key concern is the loss of lives and societal scars left by these terrible developments, but there are broader consequences as well for regional stability and superpower relations. It is already clear that the US military was finding itself stretched in weapons and ammunition production and supply due to the ever-increasing demand from Ukraine. Now, two US aircraft carriers have been deployed near the middle-east to prevent the risk of the conflict spreading, compounding concerns. US overtures to China to take a stronger stance in favour of Israel has not been fully reciprocated, underscoring the multipolar and increasingly unpredictable nature of dealing with conflicts globally.

The key risk for the global economy around the Israel/Palestine conflict is of course oil prices. Crude prices have been ascendant since July as Opec supply cuts were implemented, and got another leg up in this month as conflict risks exacerbated. We think risks have to worsen much more for oil supplies to be affected, and the chance of that remains low. One possible mitigation is that the US is talking to all parties concerned to ensure that Iran does not get ensnared. Even if Iran finds itself producing less because of tightened sanctions, there is plenty of capacity within Opec of offset that. We are therefore refraining from entertaining an oil shock for our baseline scenario.

But the global economy has already a major shock to deal with, which is interest rates. US 10-year treasury yields have risen by over 100bps this year, on top of 230bps increase in the previous year. The rapidity of this constitutes a tightening of monetary conditions of historic proportions.

Other than some regional bank failures in the US earlier this year, the damage to corporate and household balance sheets from the rise in interest rates has been remarkably modest so far. There are a few well-established reasons for that. First, at the household level, large fiscal support to earnings during the pandemic years boosted savings considerably, helping reduce reliance on credit-driven consumption. For those exposed to leverage, the zero-rate years provided time to refinance, at low rates, their long-term loans/mortgages. The transmission of higher rates has therefore been somewhat blunted for the time being.

Second, both leverage and earnings of US corporates have been largely at sound levels. Consequently, credit spreads have not widened along with rising rates. This is atypical, but understandable given firms reducing their duration risk during the zero-rate years.

Third, despite the Fed's quantitative tightening, market liquidity is ample. The Fed would have to tighten for more than a year before its balance sheet comes back to pre-pandemic levels. The legacy of QE is yet to disappear.

We however think the market is not being forward looking. The factors that have held the US economy tighter so far are beginning to unravel, but the markets remain at ease. From credit card delinquencies are rising, as are auto loan defaults. Are mortgage stresses far away? What about the next round of corporate debt refinancing? We are not comfortable.

Taimur Baig

Key forecasts for the week

Event	DBS	Previous
Oct 23 (Mon)		
Singapore: CPI (Sep)	4.1% y/y	4.0% y/y
Taiwan: industrial production (Sep)	-8.8% y/y	-10.5% y/y
Oct 26 (Thu)		
Eurozone: ECB main financing rate	4.50%	4.50%
Hong Kong: exports (Sep)	-1.0% y/y	-3.7% y/y
- imports	0.0% y/y	-0.3% y/y
- trade balance	-HKD17bn	-HKD26bn
Singapore: industrial production (Sep)	-1.8% y/y	-12.1% y/y
South Korea: GDP (3Q A)	1.1% y/y	0.9% y/y
US: GDP (3Q A)	2.5% q/q saar	2.1% q/q saar
Oct 29 (Sun)		
Vietnam: exports (Oct)	6.6% y/y	4.6% y/y
- imports	3.6% y/y	2.6% y/y
- trade balance	USD3.3bn	USD2.3bn
- Retail sales YoY YTD	9.4% y/y	7.5% y/y
- CPI	3.7% y/y	3.7% y/y

Central bank policy meetings

Bank of Canada (Oct 25): We expect the BOC to maintain its policy rate at 5%, marking a third pause. Following a brief rise to 4% YoY in August, CPI inflation reverted lower to 3.8% in September, closer to the 1-3% target range. Despite a contraction in real GDP on a QoQ saar basis in two out of the three quarters ending in 2Q23, BOC Governor Tiff Macklem remained optimistic and dismissed concerns about a recession. According to the BOC's Business Outlook Survey for 3Q23, more businesses are wary that elevated interest rates may hamper their sales and investment agenda in the forthcoming year. Concurrently, the BOC's

Consumer Expectations Survey for 2Q23 highlighted heightened inflation impelling households to curtail further spending, and prevailing high interest rates driving consumers to save and expedite debt payment. Given these dynamics, the BOC will likely revise its GDP growth projections down from the previous estimates of 1.8% for 2023 and 1.2% for 2024. Concluding, Macklem did not equate the recent uptick in long-term bond yields to a shift in the monetary policy stance.

European Central Bank (Oct 26): The ECB Governing Council is likely to take comfort from the gradual pullback in inflation and keep the benchmark rate on hold, signaling that the policy tightening moves to date will be sufficient to anchor inflationary expectations. Focus will shift towards growth (amidst recessionary fears in Germany) and on the need for fiscal prudence to contain the recent widening in bond spreads (Italian-Bund). The Italian government had earlier raised their fiscal deficit for 2023 to -5.3% of GDP from -4.5% earlier amidst plans to maintain an expansionary stance at a wide -4.3% in 2024. Besides lamenting that the ECB rate hikes will raise servicing costs by EUR15bn (and push by debt to GDP to over 140% of GDP), the government introduced measures worth EUR 24bn in tax cuts and higher expenditure next year, just as additional spending towards 'superbonus scheme' continues to be a drain.

Forthcoming data releases

Hong Kong SAR: Contraction of exports is expected to ease from 3.7% YoY in Aug 1.0% in Sep as external headwinds appeared to stabilize.

South Korea: GDP growth is expected to rise slightly on a YoY basis, reaching 1.1% in 3Q (vs. 0.9% in 2Q). The QoQ rate (saar) is projected to remain stable at 2.0% (vs. 2.5% in 2Q). The primary driving force is anticipated to be net exports, primarily attributed to the improvement in semiconductor and electronics exports. Machinery investment continued to exhibit sluggishness, as the manufacturing capacity utilization rate has not fully normalized. Furthermore, consumption growth witnessed a weakening trend in 3Q, influenced

by diminishing reopening demand and abnormal weather conditions. Looking ahead, we are anticipating a gradual recovery in GDP growth to around 2% YoY starting from 4Q23. This takes into account a further revival of the global semiconductor sector, improvements in the domestic property market, alleviating inflation pressures, stabilizing interest rates, and the resilience of labor market conditions.

Singapore: Regarding inflation, we expect the headline rate to stay rather steady at 4.1% YoY in Sep, vs Aug's 4.0% YoY. Headline inflation was supported by the increase in COE premiums, despite moderating core inflation. Core inflation likely cooled to 3.0% YoY, from Aug's 3.4%, helped by favourable base effects, lower food and import prices vs a year ago. The moderation in core inflation to around 3% would still be consistent with the Monetary Authority of Singapore (MAS)'s end-2023 core inflation forecast range of 2.5-3.0%.

On industrial production (IP), the YoY decline likely extended for the 12th straight month, but narrowed to 1.8% YoY in Sep, vs Aug's huge contraction of 12.1% YoY, in our view. Our Sep expectation is in line with the Ministry of Trade and Industry (MTI)'s implied number, based on the 5.0% YoY manufacturing fall seen in the 3Q23 advance GDP estimate. We also assumed a similar MoM sa profile as Sep's non-oil domestic exports (NODX). It appears likely that electronics production bounced back in Sep, after slumping sharply by 20% YoY in Aug.

Vietnam: Oct 2023's data will likely see a gradual improvement in Vietnam's trade, resilient retail sales expansion, and steady inflation. Despite a challenging global economic environment, Vietnam's exports returned to expansion in Sep, supported by a modest electronics recovery, which likely extended in Oct by an increase of 6.6% YoY. Vietnam's manufacturing purchasing managers' index (PMI) is already off its low point, with strength in new export orders. Retail sales likely remained supportive by the resilient labour market.

Headline inflation, which picked up more visibly in Sep and Aug, was likely steady at 3.7% YoY in Oct. Domestic retail oil prices were adjusted lower in Oct, after four straight monthly increases, while core inflation remained on a downtrend. That said, food inflation has started to pick up in Sep, and could have increased further in Oct, amid El Nino weather disruptions. With the Vietnamese dong still facing weakening pressures vs the USD, we think that the State Bank of Vietnam (SBV) will likely err on the side of caution, and maintain its accommodative monetary policy, rather than loosen further.

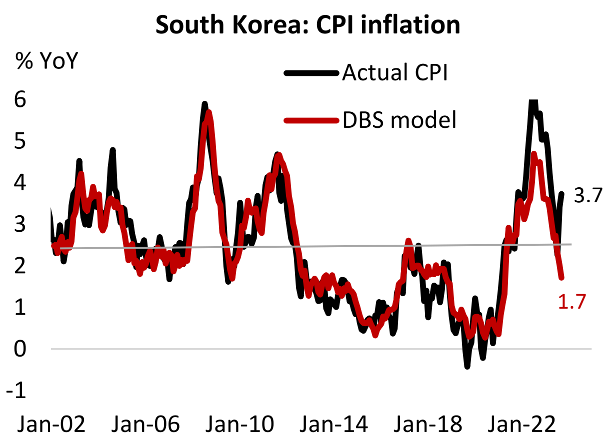
Economics Team

South Korea: Elevated inflation delays BOK rate cuts

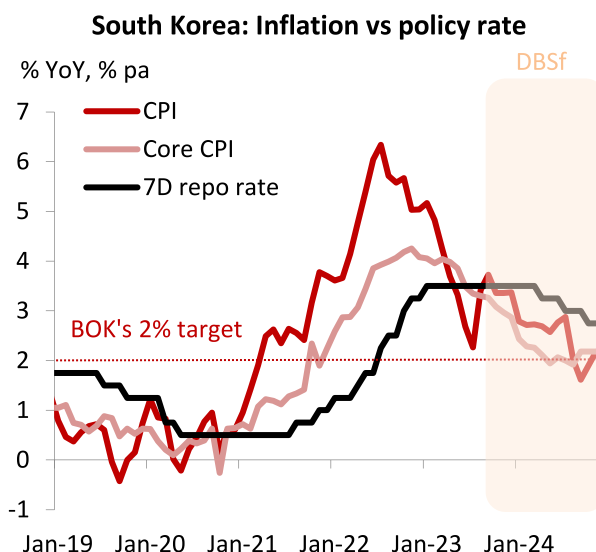
We are revising our inflation forecasts for 2023-2024, adjusting them slightly upward to 3.6% (from 3.4%) and 2.4% (from 2.0%). The deviation between actual CPI and our forecast model has widened in the recent couple of months, primarily due to the surge in domestic food prices caused by abnormal weather conditions and festival effects. Additionally, the rise in global oil prices resulting from the Hamas-Israel war poses uncertainties for the inflation path in the upcoming months. As highlighted by the Bank of Korea at the October 19th meeting, there is expected to be a delay in achieving the 2% inflation target due to the ongoing oil and FX volatility.

In line with our inflation forecast revision, we have adjusted the interest rate forecast trajectory, postponing the timing for the first BOK rate cut by one quarter from 1Q24 to 2Q24. The BOK maintained a hawkish bias at the Oct 19th meeting, emphasizing the upside inflation risks and the intention to keep monetary policy restrictive for a considerable period.

Regarding the demand-side inflation, we remain confident about the easing trend. Money supply M2 growth has slowed to just 2.2% YoY as of August, attributed to the aggressive rate hikes and tightening of monetary conditions. Given the lagging impact on the broad economy and prices, there is the potential for inflation to ease substantially in the next 12-18 months. Accordingly, we still anticipate a total of 75bps rate cuts for the entire year of 2024, bringing the benchmark repo rate to 2.75% from the current 3.50%.



Note: DBS model incorporates Brent oil, FAO food prices, consumer inflation expectations, industrial production, and M2 growth.
Source: CEIC, DBS



Source: CEIC, DBS

Ma Tieying

FX: US data surprises and ECB's pause

Over the past month, the DXY, alongside most of its components, has entered a phase of consolidation. DXY fluctuated between 105.5 and 107.5 while EUR/USD and GBP/USD oscillated within the 1.0450-1.0650 and 1.2050-1.2350 bands respectively. Besides a fleeting descent to 147.43 on 3 October, USD/JPY held a 148.2-150 range, underpinned by escalating US bond yields, yet restrained by apprehensions regarding intervention. On 18 October, amid the Middle East turmoil, USD/CHF dipped below 0.90, serving as a refuge for investors.

DXY supported at 105.90, the high in March

Sources: DBS Research, Bloomberg data

Interest rate futures are signalling a termination of rate hike cycles. The Federal Reserve, the Bank of Canada, and the Swiss National Bank have already paused at their last meetings, with the European Central Bank anticipated to follow suit this Thursday. These central banks are expected to uphold elevated rates till the first half of 2024. **The relative value favours the greenback's superior growth dynamics and highest policy rate and bond yields amongst its G7 counterparts.**

The Fed has entered a blackout period ahead of the FOMC meeting on 31 October-1 November. Should pivotal US data unveil surprises this week, **markets may change their minds about ruling out a hike this year.** On 26 October, the consensus is projecting US advanced GDP growth to rev up to 4.3% QoQ saar in 3Q23 following a four-quarter slowdown to 2.1%. If accurate, this surpasses the **long-term potential growth rate** estimated at around 2% by Fed Chair Jerome Powell. Having witnessed resilient consumer spending through business contacts, Powell deemed the policy stance as "not too tight" and was relatively unperturbed by the surge in bond yields, attributing it to term premiums, quantitative tightening, and the strong economy.

Having found September's inflation reports "somewhat less encouraging," Powell foresees a rocky descent over time. On 27 October, expectations are for the PCE deflator to slow to 0.3% MoM in September from 0.4% in August, yet the PCE core deflator is projected to increase to 0.3% MoM from 0.1%. In YoY terms, both headline and core inflation still overshoot the 2% target at 3.4% and 3.7%, respectively.

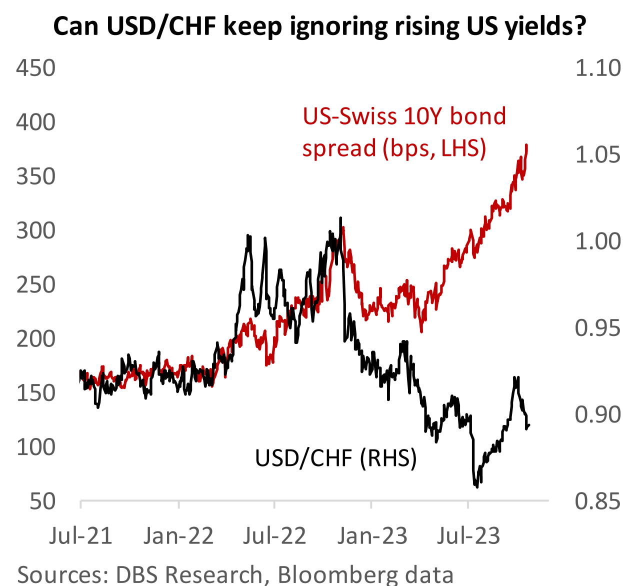
With a 0.8% appreciation to 1.0594 last week, **EUR/USD is on the verge of reverting to the lower half of its four-week range of 1.0440 and 1.0640**. Apart from robust US data, we expect the European Central Bank to pause its hiking cycle at the governing council on 26 October. The real refi rate turned positive for the first time since January 2021 due to a slump in CPI inflation from 5.3% YoY in August to 4.3% in September. Core inflation mirrored this trend and aligned with the 4.50% refi rate. This pause will allow the ECB to evaluate the impact of the unprecedented 450 bps of hikes since July 2022.

Per the CFTC, speculators added to their net short EUR positions for a second week. A Reuters poll on 20 October saw the ECB maintaining elevated rates in the first half of 2024, preceding rate cuts in the second half.

In October, USD/CAD transitioned into a higher range between 1.3550 and 1.3790 compared to 1.3380-1.3550 in late September. The positive US-Canada 10Y bond yield differential widened by 30 bps to 84 bps this month, making it the broadest spread since April 2019. We see the Bank of Canada maintaining its policy rate at 5% for a third meeting on 25 October. Elevated interest rates are prompting consumers to save more and pare down mortgage debt, and are also deterring businesses from aggressive sales and investment strategies in the upcoming year. While the BOC does not anticipate a recession, a downward revision in GDP growth forecasts from the prior estimates of 1.8% for 2023 and 1.2% for 2024 is probable.

GBP/USD's slight 0.2% ascent to 1.2164 last week barely lifted it above its four-week range floor of 1.2030 to 1.2340. The Bank of England will likely maintain the bank rate at 5.25% for a second time during its meeting on 2 November. BOE Governor Andrew Bailey sees CPI inflation declining markedly in October after plateauing at 6.7-6.8% over the past three months. Following recent by-election losses in Tamworth and Mid Bedfordshire, Prime Minister Rishi Sunak could confront a Conservative Leadership crisis, with escalated pressure from right-wing factions to lower stamp duties and trim taxes for the top five million earners. However, Chancellor Jeremy Hunt, amid a fragile economy burdening government revenues and a hefty national debt service cost, cautioned against fiscal flexibility at the Autumn Budget announcement on 22 November. **Hence, a retest of the 1.20 or even March's 1.18 low by GBP/USD isn't out of the question.**

Can USD/CHF keep ignoring rising US yields?



Sources: DBS Research, Bloomberg data

USD/CHF, peaking at 0.9244 on 3 October, plunged to 0.8921 from the CHF becoming a haven from the Middle East crisis. Nevertheless, the 100-day moving average acted as a notable support level keeping USD/CHF above 0.89. As markets deduce a pause by both the Fed and the Swiss National Bank have paused, USD/CHF appears undervalued, especially with the US-Swiss 10Y bond differential expanding to 376 bps on the back of US' stronger growth and higher inflation, a significant leap from the 302 bps spread last November. Given Switzerland's inflation is within its 0-2% target amid subpar growth, the SNB has fewer incentives to uphold a strong CHF.

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