Economies, Currencies, Rates

Daily Breakfast Spread

DBS Group Research 4 July 2013

Economics

Greater China, Korea

- **CN**: The push to internationalize the RMB may not be the driver behind all the changes underway in China, but it's certainly consistent with them. China, of course, is changing the growth model – trying to slow things down, make consumption more of a driver, reduce dependence on exports and investment, clean up and liberalize the financial sector, cut pollution, move development inland and raise productivity more cheaply by putting more people in cities, i.e., through urbanization.

  That's a long list, so if globalizing the currency is on it too, it's nice to know it 'fits'. What do you need if companies and fund managers and central banks are going to hold your currency and use it for everything that they use the dollar and euro for today? Well, 'trust' mostly, but what does that translate into in practical terms? First off, you need a clean, well regulated financial sector that functions crisply and transparently. Shadow banking doesn't fit the bill and it's not surprising that the squeeze is on. Second, you need stable, manageable growth that doesn't choke the cities and that investors can trust to run day in, day out for a long long time. Slower growth fits this bill.

  And you need a strong (perhaps slightly overvalued) currency so that when the capital account opens up you don't get flooded with inflows. They've spoiled a lot of well laid plans. Recent and continued RMB appreciation is certainly consistent with this. It's also consistent with stronger consumption and weaker exports, part of the overall shift in economic emphasis sought by the authorities.

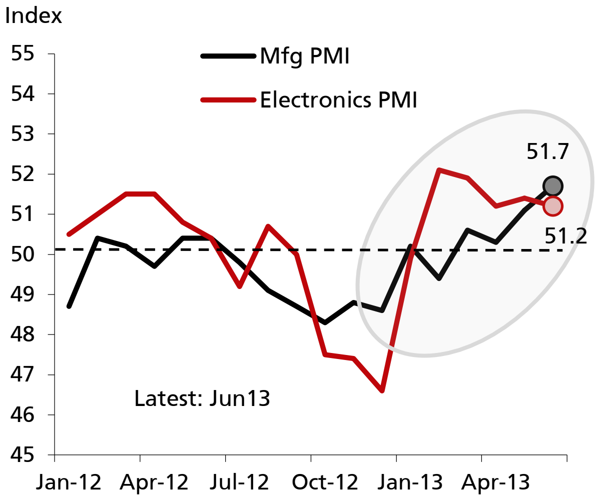
  You need other things, too, but these three – slower growth, a cleaner financial sector and a strong currency – are key and they go hand in hand with the broader shifts underway in China. There's a lot to do; handshaking helps.

Southeast Asia, India

- **SG:** PMIs were out last evening and they certainly live up to expectation. The overall manufacturing PMI came in stronger than the previous month, rising 0.6 point to 51.7 in June (see Chart). Electronics PMI eased 0.2 point to 51.2.

  Essentially, this latest set of PMI numbers highlights that the manufacturing sector is nicely on a firm recovery path. This makes for stronger manufacturing as well as GDP growth in the second quarter, compared to the slump in 1Q13.

SG: PMIs pointing to better mfg growth



US Fed expectations

Source: Bloomberg fed fund futures

Implied fed funds rate

	Jun13	Dec13	Jun14
Market			
Current	0.09	0.14	0.23
1wk ago	0.10	0.15	0.22
DBS	0.25	0.25	0.25

Notes: Given a FF target rate of 0.25%, an implied FF rate of 0.30 is interpreted roughly as the market pricing in a 20% chance of a Fed hike to 0.50% from 0.25% (30 is 1/5th of the distance to 50 from 25). DBS expectations are presented in discrete blocks of 25bps, i.e., the Fed moves or it does not. See also "Policy rate forecasts" below.

However, the global outlook still looks dicey. The US recovery remains mixed while Europe is still in recession. China is going through an internal consolidation, which could spill over to the rest of Asia. Indeed, the PMIs from some of our key trading partners are already reflecting that. Plainly, we expect the PMI to ease gradually closer to the 50 level in the coming months.

In fact, there are some tell-tale signs within this set of PMIs on the above view. For example, the new orders and import indices have eased off, suggesting anticipated tapering off in demand ahead. Inventory levels appear to have peaked while the stocks of finished goods are rising, essentially pointing to slower production in the coming months.

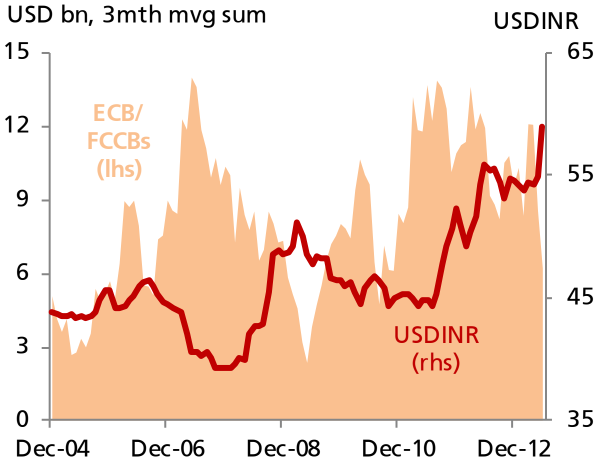
- **IN:** In a bid to give its warnings some teeth, the RBI proposed to mandate higher provisioning by banks against loans to corporates with unhedged foreign currency exposure. The measure is still in the consultation phase and financial institutions have until early-Aug13 to provide feedback on these regulations. Once finalised, the rules might become effective Oct13 onwards.

These proposed rules are not without reason. Domestic corporates were encouraged to raise foreign currency loans to meet financing requirements, as an alternative to high borrowing costs at home and to tap low offshore rates. While the former still holds, the latter is shifting northward, especially as the markets adjust to the possibility of Fed QE3 withdrawal. Rising US rates have narrowed the rate advantage that the corporates had tapped earlier, thus making it increasingly less cost-effective. Meanwhile, the associated foreign currency exposure has become relevant in wake of recent substantial rupee depreciation and subsequent jump in the repayment burden.

As the accompanying chart shows, the scale of external commercial borrowings and foreign currency convertible bonds have been on the climb after the brief dip during the global financial crisis. Much of the sharp rise in these borrowings occurred when USD/INR was around 52.0, with the recent run-up likely to see redemptions face a firm 59.0-60.0, especially if the loans was left unhedged. Assuming a USD 100 loan at 6mth Libor + 500bps basis, the repayments could jump by 12% on just INR7 slippage. This highlights the additional stress on the corporate balance sheets, at a time when profitability has already taken a hit on slowing demand and high borrowing costs. In May, the central bank had estimated that about 60% of corporate loans were unhedged.

At the other side of the coin, the RBI is focused on shielding the domestic banking sector from probable corporate defaults. The operating environment for the banking sector is already far from ideal in midst of slowing deposit growth, tight liquidity conditions, lacklustre growth prospects and delayed infrastructure/priority sector loans, amongst others. This has shown in the RBI's recent Financial Stability Report, where gross NPAs for public-sector banks improved a notch to 3.4% in Mar13, from 3.6% in Sep12, but is still up from 2.95% in Mar12. The rules surrounding restructuring of loans have also been tightened, especially as the latter was increasingly being used to contain extent of asset quality deterioration. On a related note, loans

IN: ECB and Fgn currency bonds vs exch rate



extended to the industry and services sector made up bulk of the restructured loans and given that these also account for a good part of the credit market, the downside risks on the banking sectors' finances could be significant. In addition, banks' capital needs are also expected to increase in the run up to the Basel III implementation and might further strain the banks' books. In sum, while the RBI calls on the corporates to ensure FX loans are adequately hedged, there is also a need to safeguard the banking system from any systemic risks.

G3

- **EZ**: The ECB Governing Council meets today and is expected to leave the main refinance rate steady at 0.5% for the second consecutive meeting. That will leave the deposit facility rate at 0%. Despite the bank being 'technically ready' for a negative deposit rate, we do not think the move is imminent. The accompanying official commentary, however, is likely to maintain dovish undertones. This has become more relevant since expectations of change in the Fed policy outlook have pushed Eurozone bond yields higher on the assumption that the European authorities might need to follow suit. The policymakers, thereby, will be hard to work to contain policy tightening expectations, with the ECB executive board member Coeure signalling the need for forward guidance. Expect the Q&A session to provide some details on the latter.

  In essence, the pressure to lower rates from the data perspective has dissipated in the last month. Most confidence indices and PMI-manufacturing appear to have stabilised tentatively. The scale of decline in industrial production in the currency-area has also been easing up, though weak consumption growth will prevent a sharp pick-up in factory output. Inflation remains benign. In the meantime, the transmission mechanism remains frozen and thereby any further reduction in the benchmark rate is unlikely to materially budge the retail/ corporate borrowing rates. In all, the path of least resistance for the central bank will be to ensure that the policy expectations are well-anchored and stress is on the availability of the OMT facility to keep yields from nearing precarious levels.

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Economic calendar

Event	Consensus	Actual	Previous
Jul 1 (Mon)			
KR: CPI (Jun)	1.1% y/y	1.0% y/y	1.0% y/y
KR: exports (Jun)	0.1% y/y	-0.9% y/y	3.2% y/y
- imports	-0.5% y/y	-1.8% y/y	-4.6% y/y
TH: CPI (Jun)	2.4% y/y	2.3% y/y	2.3% y/y
ID: CPI (Jun)	6.0% y/y	5.9% y/y	5.5% y/y
ID: exports (May)	-8.8% y/y	-4.5% y/y	-9.1% y/y
- imports	-5.9% y/y	-2.2% y/y	-3.7% y/y
EZ: CPI (Jun)	1.6% y/y	1.6% y/y	1.4% y/y
EZ: unemployment rate (May)	12.3%	12.1%	12.2%
US: ISM manufacturing (Jun)	50.5	50.9	49
Jul 2 (Tue)			
HK: retail sales (May)	16.6% y/y	12.2% y/y	19.4% y/y
Jul 3 (Wed)			
EZ: retail sales (May)	0.3% m/m sa	1.0% m/m sa	-0.2% m/m sa
US: ADP employment change (Jun)	160K	188K	134K
US: ISM non-manf. (Jun)	54.0	52.2	53.7
Jul 5 (Fri)			
TW: CPI (Jun)	0.6% y/y		0.7% y/y
PH: CPI (Jun)	2.7% y/y		2.6% y/y
MY: exports (May)	-3.0% y/y		-3.3% y/y
- imports	2.9% y/y		9.2% y/y
US: change in nonfarm payrolls (Jun)	165K		175K
US: unemployment rate (Jun)	7.5%		7.5%

Central bank policy calendar

Date	Country	Policy Rate	Current	Consensus	DBS	Actual
This week						
04-Jul	Ezone	7-day refi rate	0.50%	0.50%	0.50%	
Next week						
07-Jul	TH	1 day repo	2.50%		2.50%	
11-Jul	KR	7 day repo rate	2.50%		2.50%	
11-Jul	MY	OPR	3.00%		3.00%	
11-Jul	ID	o/n reference rate	6.00%			
11-Jul	JP	o/n call rate	0.10%		0.10%	
		2014 base money target	JPY 270trn		JPY 270trn	
Last week						
27-Jun	TW	disc rate	1.875%	1.875%	1.875%	1.875%

GDP & inflation forecasts

	GDP growth, % YoY					CPI inflation, % YoY				
	2010	2011	2012	2013f	2014f	2010	2011	2012	2013f	2014f
US	3.0	1.8	2.2	1.6	2.4	1.6	3.1	2.1	1.6	2.0
Japan	4.5	-0.6	2.0	1.8	0.9	-0.7	-0.3	0.0	0.0	2.0
Eurozone	1.9	1.6	-0.5	-0.6	0.1	1.6	2.7	2.5	1.5	1.9
Indonesia	6.1	6.5	6.2	6.0	6.3	5.1	5.4	4.3	6.7	6.4
Malaysia	7.2	5.1	5.6	5.0	5.5	1.7	3.2	1.7	2.0	2.4
Philippines	7.3	3.6	6.8	6.4	6.0	3.8	4.8	3.1	3.1	4.0
Singapore	14.8	5.2	1.3	2.5	4.0	2.8	5.2	4.6	2.8	3.6
Thailand	7.8	0.1	6.4	4.6	5.2	3.3	3.8	3.0	2.9	3.7
Vietnam	6.8	5.9	5.0	5.3	5.7	9.2	18.6	9.3	6.7	6.8
China	10.3	9.3	7.8	7.5	8.5	3.3	5.4	2.6	3.5	3.5
Hong Kong	7.0	4.9	1.5	3.5	4.0	2.4	5.3	4.1	4.5	3.5
Taiwan	10.7	4.1	1.3	2.6	4.2	1.0	1.4	1.9	1.0	1.3
Korea	6.2	3.6	2.0	2.8	4.0	2.9	4.0	2.2	1.5	2.9
India*	8.4	6.5	5.0	5.7	6.1	9.6	8.9	7.4	6.7	7.0

* India data & forecasts refer to fiscal years beginning April; inflation is WPI
Source: CEIC and DBS Research

Policy & exchange rate forecasts

	Policy interest rates, eop					Exchange rates, eop				
	current	3Q13	4Q13	1Q14	2Q14	current	3Q13	4Q13	1Q14	2Q14
US	0.25	0.25	0.25	0.25	0.25	...	...	...	...	...
Japan	0.10	0.10	0.10	0.10	0.10	100.0	100	102	104	105
Eurozone	0.50	0.50	0.50	0.50	0.50	1.302	1.31	1.32	1.34	1.35
Indonesia	6.00	6.50	6.50	6.50	6.50	9,977	9,850	9,800	9,750	9,700
Malaysia	3.00	3.00	3.00	3.00	3.00	3.19	3.02	2.99	2.96	2.94
Philippines	3.50	3.50	3.50	3.75	4.00	43.5	41.5	41.0	40.5	40.0
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	1.27	1.24	1.23	1.21	1.19
Thailand	2.50	2.50	2.50	2.50	2.75	31.1	29.9	29.8	29.7	29.6
Vietnam^	7.00	7.00	7.00	7.00	7.00	21,218	21,100	21,200	21,300	21,400
China*	6.00	6.00	6.25	6.25	6.50	6.13	6.09	6.06	6.03	6.00
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.	7.75	7.77	7.78	7.79	7.80
Taiwan	1.88	1.88	1.88	2.00	2.13	30.1	29.6	29.4	29.2	28.9
Korea	2.50	2.50	2.50	2.75	2.75	1144	1100	1080	1060	1040
India	7.25	7.00	7.00	7.00	7.00	60.2	56.2	56.6	57.0	57.4

^ prime rate; * 1-yr lending rate

Market prices

	Policy rate	10Y bond yield		FX		Equities		
	Current (%)	Current (%)	1wk chg (bps)	Current	1wk chg (%)	Index	Current	1wk chg (%)
US	0.25	2.50	3	83.2	0.3	S&P 500	1,615	0.8
Japan	0.10	0.87	1	100.0	-1.6	Topix	1,174	9.8
Eurozone	0.50	1.66	-11	1.302	-0.2	Eurostoxx	2,598	-0.1
Indonesia	6.00	7.35	15	9977	-0.1	JCI	4,577	-0.2
Malaysia	3.00	3.59	-16	3.19	0.4	KLCI	1,769	1.6
Philippines	3.50	4.27	-11	43.5	-0.1	PCI	6,480	5.9
Singapore	Ccy policy	2.47	-9	1.272	-0.4	FSSTI	3,129	0.8
Thailand	2.50	3.65	-25	31.1	0.3	SET	1,444	4.3
China	6.00	...	...	6.13	0.3	S'hai Comp	1,994	2.2
Hong Kong	Ccy policy	2.11	-3	7.75	0.1	HSI	20,147	1.5
Taiwan	1.88	1.45	145	30.1	0.1	TWSE	7,911	1.6
Korea	2.50	3.45	-5	1144	0.9	Kospi	1,825	2.3
India	7.25	7.51	5	60.2	0.8	Sensex	19,178	3.4

Source: Bloomberg

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