DBS Wealth

DBS

Investment Insights

Monday, 17 August 2015

The World, Seen Through China

SUMMARY

- **Equities bull market has been running out of steam around the world, exacerbated by Chinese stock volatility and yuan devaluation**
- **Another Asian financial crisis unlikely, but expect an uncomfortable ride with a downside in stocks. We recommend a shift to quality in both stocks and bonds**
- **Worries over a Chinese slowdown are legitimate, but don't panic over its impact on the world**
- **Developments in China are unlikely to affect the timing of US rate hikes; US data is more important**
- **A weaker yuan plus Fed rate hikes would be a toxic combination for emerging market equities**

The equities bull market has been running out of steam all over the world from its April-June peaks. A combination of factors may have been at play – valuations, rising risk ahead of the potential start of a rate hiking cycle in the US, and a looming new bear cycle in emerging markets.

These threats to global equities have been exacerbated by extreme volatility in Chinese stocks, and last week, by the yuan devaluation. Although the USD/CNY has eased off the peaks around 6.45 from last week, the risks to the cross appear to be on the upside – that is, more yuan weakness. And this has implications for the rest of the world. For Asia ex-Japan, there will be continued downside pressure for currencies, with negative implications for equities. Those with memories of the 1990s will note, with some discomfort, the coincidence of sharp yuan devaluation and the commencement of a US Federal Reserve rate hiking in 1994; a deep slump in the yen starting in 1995; and the Asian Financial Crisis in 1997-1999. A new Asian Financial Crisis is unlikely because: leverage is lower, reserves are higher, the yuan devaluation is likely to be modest compared to 1994, and Asian currencies are more flexible today. But an uncomfortable ride is likely over coming months – with more downside likely in stocks. Last week, we recommended de-risking portfolios. We have taken weights off equities, bringing us to neutral weight, after years of being overweight stocks. And we recommended a shift to quality, in both stocks and bonds.

The week when everything revolved around China. Global equities ended the week 0.4% down as the surprise devaluation of the yuan triggered a flight to safety. Developed markets equities lost 0.2%, led by the 1.3% decline in Europe and 1.1% decline in Japan (both in dollar terms). The S&P 500, on the other hand, managed to gain 0.7%. The weekly outperformance of US equities over their European counterparts came with a sharper appreciation of the euro against the yuan (Figure 1) as compared to the dollar. This weighs heavily on European exporters with large exposures to China. Emerging markets lost 2.4%.

Fig 1: Sharp appreciation of the euro against the yuan

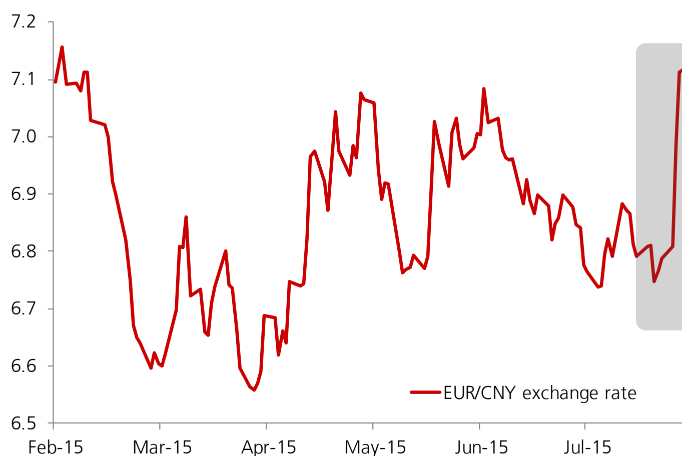


Fig 2: Rising China unit labour cost damages competitiveness

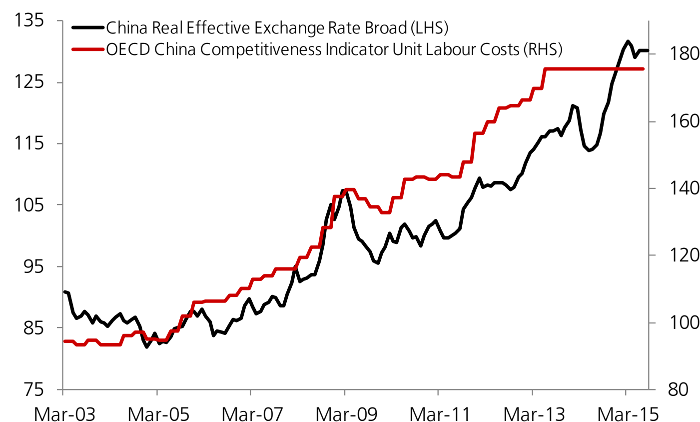
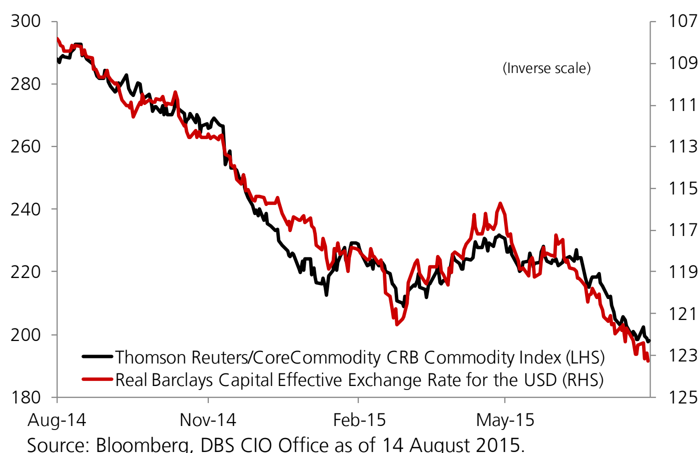


Fig 3: Relationship between commodities and USD REER



Source: Bloomberg, DBS CIO Office as of 14 August 2015.

The Bloomberg JP Morgan Asia Dollar Index lost 2.0% amid talk of a rising "currency war". Reaction in the bond space was mixed. In Europe, the flight to safety trade drove German Bunds 10-year yield slightly lower. However, the US Treasury (UST) 10-year yield traded slightly higher, despite the overall risk-off environment. This is likely attributed to two things. One, yuan depreciation and the consequential USD strength lifted expectations the Fed might delay its policy rate lift-off, since a stronger USD was a form of monetary tightening. Two, healthy retail sales and jobs data suggest that the US economic recovery is on track. The weakness in commodities worsened as Chinese growth concerns drove the Thomson Reuters/CoreCommodity CRB Commodity Index 0.2% lower.

Worries over China's economic growth are legitimate. Economic activity in China has slowed and is likely to continue slowing. Hence the government's aggressive interventions – fiscal, monetary and regulatory – since the middle of last year. We see last week's yuan devaluation through the prism of policy moves made during the past 12 months. The motivations might have also involved current market reform, to better position the yuan to become one of the reserve currencies in the International Monetary Fund's Special Drawing Rights group. But it was not lost on the market that the move also came as Chinese exports had been struggling in contraction territory since the start of the year. Industrial production growth (on-year) has been fallen dramatically from the peak in 2010, signalling a deeper slump into contraction by the manufacturing purchasing managers' index (PMI). Over a longer timeframe, the surge in China's Unit Labour Cost since 2010 has damaged manufacturing competitiveness (Figure 2). In a nutshell, contrary to past criticisms in the West of China's "undervalued" currency, the yuan would appear to be overvalued.

But panic over the impact of slower Chinese growth on the world is unnecessary. China's growth is not falling off a cliff. It is in a – still controlled – growth descent. The next thing to say is even as China's growth has slowed from, say, ten years ago, its absolute size means that its contribution to global growth actually could even rise a bit more. This point was made last year by Steven Barnett, the Division Chief in the Asia and Pacific Department of the International Monetary Fund (IMF). "In 2003-2007, China averaged 11.7% growth whereas in the coming five years (2015-19) we expect growth to average 'only' 6.8%. Yet, because China's economy is much bigger, the average contribution to global growth will actually increase slightly—rising from 1.0 (2003-7) to 1.1 (2015-19) percentage points," Mr Barnett wrote.

A slower China and a mildly weaker yuan are unlikely to affect the Federal Reserve's decision on rates – US domestic data more important. The stabilisation of the USD/CNY from late last week suggests events of the past week may not factor into the Fed's decision. Of course, in theory, the devaluation would weaken the probability of a September rate hike. But if the Fed had already reckoned the US economy was ready for a symbolic start to rate normalisation, the yuan devaluation is unlikely to knock it off course. For starters, the US runs a trade deficit with China. It relies less on Chinese demand than China depends on US demand. The impact on US GDP growth and prices should not be significant enough to affect the Fed's calculations on rates. Indeed, domestic data bears closer watching by contrast. In that regard, data last week confirmed our argument that the US remains the strongest of a weak bunch of developed market economies. US industrial production came in stronger than expected at 0.6% on-month in July. Retail sales rose 0.6% on-month in July, in line with consensus forecast. And the jobs market in the US continued to improve as initial jobless claims for week ending 8 August rose 274,000, slightly higher than the consensus forecast of 270,000. This brings the weekly average to 283,000, compared to an average of 308,404 in 2014. But the University of Michigan consumer sentiment index weakened to 92.9 in August from 93.1 in July.

But a weaker yuan and Fed rate hike would be a toxic combination for emerging market equities. We had been Underweight emerging market equities for quite some time now. Our concerns were the strength of the US dollar, weak commodity prices, and expected Fed rate hikes. We can now add a weakening yuan to that combination. The Thomson Reuters/CoreCommodity CRB Index softened further last week although the US dollar index DXY actually weakened over the same period. At the fundamental level, the market was concerned about the yuan devaluation. This signalled weaker Chinese demand for commodities flowing from slower growth and resulting in more expensive yuan-denominated cost of commodities. But at the technical level, there is a very clear relationship between the commodities index and the US dollar real effective exchange rate (Figure 3). This speaks of the impact of the yuan devaluation on commodities and via that, emerging market assets. Macro economics aside, idiosyncratic factors in many emerging markets have been unfavourable as well. 1) Malaysia with a political schism within the ruling United Malay National Organisation (UMNO) over Prime Minister Najib Razak's handling of the 1MBD affair; 2) Thailand with its long, unresolved political divide between urban and rural-based political forces; 3) Indonesia with disappointment over President Joko Widodo's struggles with economic reform; 4) Brazil, with the political fallout over the widening probe over corruption allegations associated with Petrobras; and 5) Russia's deepening recession. European emerging market economies are vulnerable as a result of their high exports to GDP ratios. Within Asia, Malaysia, Thailand, Vietnam and Taiwan also have high exports to GDP numbers. Regardless of China's intentions, the depreciation of the yuan will add competitive pressures to these economies. So their currencies have also depreciated against the dollar to keep the decline in China's real effective exchange rate much smaller than the decline against the dollar. If this is a minor adjustment to ease monetary conditions slightly in China, the impact on emerging markets will be manageable. But if this is part of a strategy to prevent the hollowing out of China's manufacturing industry, it spells deep and long-term trouble for other emerging market economies, if it results in the re-shoring of low cost manufacturing back to China.

The Week Ahead:

Monday:

- The US will release its Empire State Manufacturing index and NAHB Housing Market index for August. The Empire State Manufacturing is expected to rebound to 4.50 from 3.86.

Tuesday:

- Look out for US housing starts and building permits data for July. Consensus forecast expects: Housing starts (+1.0% on-month) and Building permits (-8.0% on-month).

Wednesday:

- Japan looks forward to trade data for July. Consensus expects the trade deficit to narrow to –JPY53.0 billion from –JPY70.5 billion. Import growth is expected to deteriorate to -7.6% on-year from -2.9%.
- In US, keep a lookout for July's inflation data. Based on consensus forecast, headline inflation is expected to moderate to 0.2% on-year from 0.1%, while "core" inflation is expected to remain unchanged at 1.8% on-year.

Thursday:

- US will release initial jobless claims, existing home sales and Philadelphia Fed Business Outlook data.

Friday:

- The Euro Area looks out for consumer confidence data.

Insights Feature

Asset Allocation: De-risk Portfolios as Currency War Meets Fed Rate Hike

China's currency devaluation has created a lot more uncertainty in markets already nervous about the expected Fed rate hike. In our outlook for 2H-2015, we spoke of our concern over the rising risks in financial/asset markets. That is, "financial markets have become a much more dangerous place" than even six months earlier. Stocks and bonds, we warned, were priced "for perfection in an imperfect world". The risks have gone even higher over the last few days as a result of China's devaluation of the Yuan. Actually, the way it has been configured, it is both a devaluation and what looks like a freeing up of the Chinese Yuan to market forces. And with market forces allowed a freer hand, the value of the CNY has been heading down rather than up, as the consensus thought likely a couple of years ago. This ratchets up uncertainty and risk because:

1) The Chinese government appears to have become alarmed at the rate of the slowdown in the economy;

2) This could signal a retreat back to an export and infrastructure-driven economic model;

3) It will send currency tremors through emerging markets and Asia ex-Japan, triggering competitive devaluations through the rest of the world;

4) Coming on the "eve" of the expected Fed rate hike in September, this could drive the US Dollar yet higher against a range of currencies, adding to pressures on US corporate earnings and the economy more broadly;

5) Many will remember what happened in the 1990s, when the Fed started to hike rates March 1994. That coincided with a steep devaluation of the CNY. What followed was, as they say, "history".

Asian Financial Crisis Redux is unlikely but an uncomfortable ride is a realistic prospect. China's 33% devaluation early in 1994 was a competitive challenge to other Asia ex-Japan economies. But it wasn't the only currency challenge. In 1995, the Yen started falling against the US Dollar. It fell 45% by mid-1998. So there are parallels between the late-1990s, and the current situation for Asian currencies vis-à-vis the Yen as well. In the 1990s, Asian central banks intervened extensively in the currency markets, turning supposed managed/"dirty" floats – where market forces should have been allowed to predominate – into de facto Dollar pegs. So these currencies stored up tensions and loss of competitiveness caused by their currency appreciations against the Yuan and the Yen, eventually exploding into a financial crisis.

The risks are lower this time because currencies float more freely, leverage is generally lower, and forex reserves generally higher.

The caveat is central banks should resist the temptation to intervene to shore up their home currencies. So the transmission of currency volatility will be – and should be – more immediate. Note that the CNY real effective exchange rate has come down by only half the currency's decline against the US Dollar, meaning other Asian ex-Japan currencies have taken their hits against the Dollar as well. This will prevent a build-up of tensions/loss of competitiveness.

But it will roil markets. Part of that relates to allegations of "growth panic" in China. Asian ex-Japan, ex-China equities – particularly those bought as plays on China's growth – will suffer. Part of that will be caused by currency discomfort. US Dollar investors will be even less inclined to maintain assets in Asian currencies if China devaluation meets a Fed rate hike to drive the Dollar yet higher. And those with no direct investments in Greater China may simply sell other Asian ex-Japan assets as a proxy play for Chinese equities and currency weakness. Collateral damage.

And if the Fed commences its rate hiking cycle in September, as many in the market expect, the pressure will mount. At the simplest level, higher rates and yields in the US will make Asian assets less attractive. At the very least, investors will demand higher returns – and hence lower prices – to hold Asian assets. Some comfort in this regard is that the Fed is unlikely to hike rates aggressively after the initial lift-off. Indeed, if the Dollar strengthens much further against the rest of the world over coming weeks, the Fed might even delay the September lift-off. It would say the currency market had already done the tightening for it. Then down goes the Dollar. How then will the Chinese respond? Therein lies the unpredictability and volatility that markets fear.

Much depends on China's intentions. The People's Bank of China's (PBOC's) media conference on Thursday gave some measure of comfort to the market, which now hopes it means a return of stability to the CNY. The PBOC said there was no basis for depreciation to persist and policy makers would intervene to control large fluctuations. But uncertainty and confusion will likely linger. Wasn't the change in the fixing of the Yuan supposed to herald a move towards liberalisation of the Yuan? That is, market forces should be the dominant driver since each morning's fixing will be determined by market makers' quotes and the close. But now the PBOC reckons it will still be intervening to limit the decline. So how much is acceptable per day, per week, and how long will this go on for? Markets will gradually return to some normality if it is shown over time that this was a one-week wonder.

One reason to doubt this is a one-week affair is the reported drawdown of China's foreign exchange reserves, which hints that the PBOC may have been using its reserves to buy the CNY – to strengthen it – rather than to weaken the CNY, which it had often been accused of doing. And in the end, they may have decided it was too costly and to what purpose? To pursue a long-term strong Yuan policy which was at odds with the immediate need to shore up exports. Viewed together with other policy measures taken over the past 12 months – and most recently, the reports of the likely issuance of infrastructure bonds – a picture emerges of a government deeply concerned with the slowing of growth.

Meanwhile, asset prices in many parts of the world are vulnerable to a significant correction. Prices in many markets are priced for perfection. But corporate earnings are slowing in the US, in part due to the cyclical peaking of operating profit margins, in part due to the strength of the Dollar. China and currency volatility more broadly will provide reasonable cause for investors to take money off the table. We are recommending that investors take some weight off risk assets.

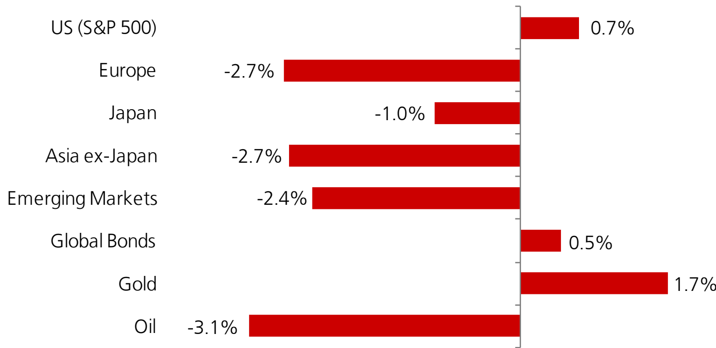
So we will:

- Downgrade equities from overweight to neutral. Within equities, we are already Neutral on the US. We now also downgrade Japan from Overweight to Neutral but will keep Europe on a small Overweight on the corporate earnings growth that we expect to flow from the dramatic decline in the value of Euro (currency) over the past year. Emerging Markets will remain Underweight.
- Bonds generally remain Underweight.
- Continue to Overweight hedge funds
- Upgrade gold from Neutral to Overweight as the undeclared currency war rolls on, with China apparently the latest entrant.
- Shift to quality in the portfolio. Focus on higher quality credits. Buy blue chip equities on corrections. Look for low-correlation hedge funds. Trade long the Dollar against selected currencies.

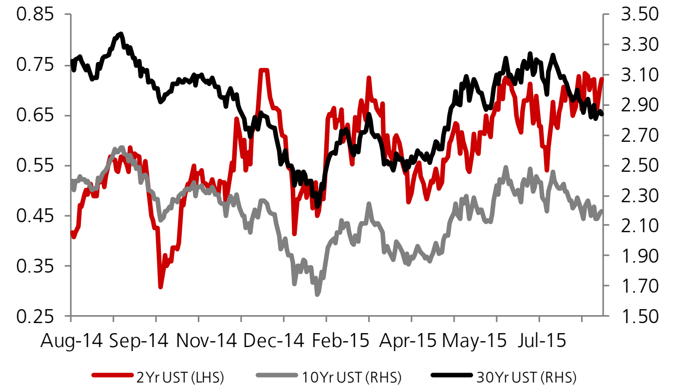
Written by Lim Say Boon, Chief Investment Officer, DBS Bank.
13 August 2015

Economic & Market Data Monitor

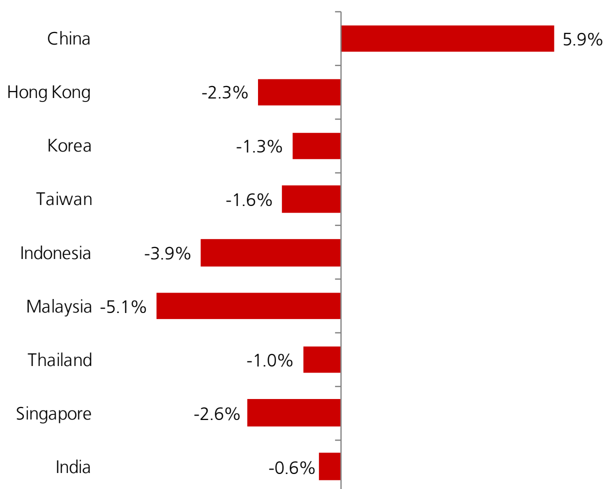
Leading Global Returns



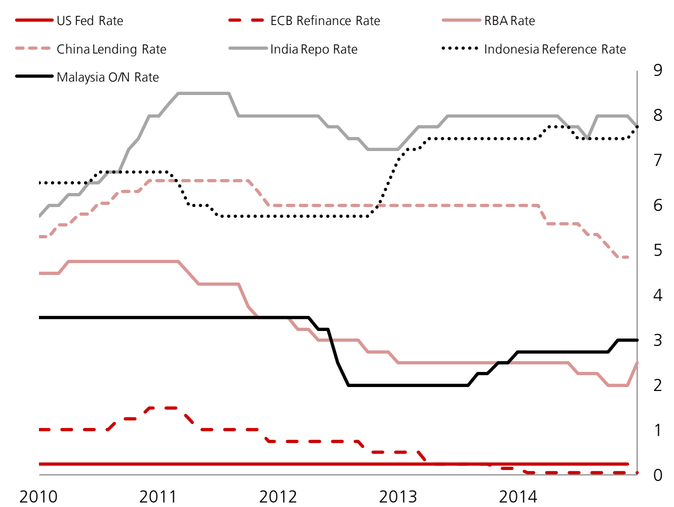
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



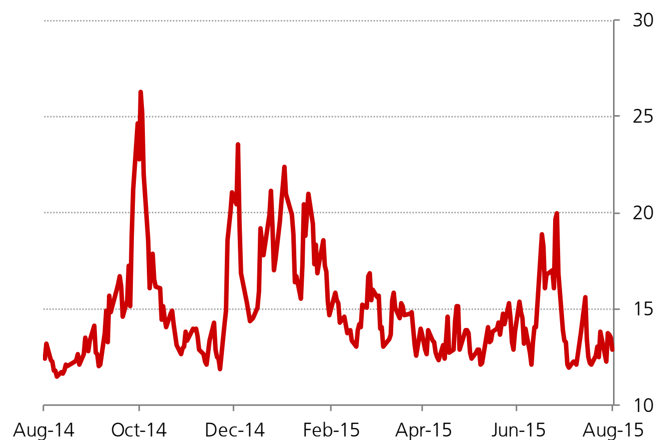
Key Forward PE & Earnings Growth

	YTD* Returns	12-month Fwd P/E	5-Year Average	Earnings Growth 2015**
US (S&P 500)	1.6%	17.7	14.7	4.8%
Europe (DJ Stoxx 600)	12.8%	16.5	13.1	36.4%
Japan (Nikkei-225)	17.6%	19.5	14.9	10.4%
Asia ex-Japan (MSCI)	-6.5%	12.2	12.3	-6.0%
Emerging Mkt (MSCI)	-9.7%	12.0	11.3	4.5%
Global Bonds	-2.4%	n.a.	n.a.	n.a.
China (SHCOMP)	22.6%	16.1	10.3	24.8%
Hong Kong (HSI)	1.6%	11.8	11.4	-13.3%
Korea (Kospi)	3.5%	11.8	10.6	15.9%
Taiwan (TWSE)	-10.8%	12.1	14.7	3.7%
Indonesia (JCI)	-12.3%	14.9	15.3	64.6%
Malaysia (KLCI)	-9.3%	14.7	15.8	6.2%
Thailand (SET)	-5.6%	14.8	13.7	19.7%
Singapore (STI)	-7.5%	13.1	14.3	5.7%
India (Sensex)	2.1%	16.9	15.7	31.3%

* YTD refers to Year-to-date; Returns in local currency.
** Earnings growth based on local benchmark index, except for South Korea (MSCI Korea).

Source: Bloomberg, IBES, DBS. Data as of 14 August 2015.

Volatility (VIX Index)



In The Coming Week

17-Aug	Event	Period	Survey	Prior
US	Empire Manufacturing	Aug	5	3.86
US	NAHB Housing Market Index	Aug	61	60
TH	GDP (YoY)	2Q-15	2.8%	3.0%
PH	Overseas Remittances (YoY)	Jun	5.4%	5.8%
18-Aug	**Event**	**Period**	**Survey**	**Prior**
CH	Property Prices	Jul	--	--
HK	Unemployment Rate (sa)	Jul	3.2%	3.2%
US	Housing Starts	Jul	1200K	1174K
US	Building Permits	Jul	1210K	1343K
ID	Trade Balance (USD billion)	Jul	511	477
ID	BI Reference Rate	18-Aug	7.5%	7.5%
ID	Exports (YoY)	Jul	-8.75%	-12.8%
AU	RBA Meeting Minutes	Aug	--	--

19-Aug	Event	Period	Survey	Prior
MA	CPI (YoY)	Jul	2.9%	2.5%
US	CPI (MoM)	Jul	0.2%	0.3%
US	FOMC Meeting Minutes	--	--	--
JP	Trade Balance (JPY billion)	Jul	-53	-69
20-Aug	**Event**	**Period**	**Survey**	**Prior**
TA	Export Orders (YoY)	Jul	-4.1%	-5.8%
US	Initial Jobless Claims	15-Aug	270K	274K
US	Existing Home Sales	Jul	5.42M	5.49M
US	Philadelphia Fed Bus. Outlook	Aug	7	5.7
21-Aug	**Event**	**Period**	**Survey**	**Prior**
US	Markit Manufacturing PMI	Aug P	53.8	53.8
GE	GfK Consumer Confidence	Sep	10.1	10.1
EC	Consumer Confidence	Aug A	-6.9	-7.1

Source: DBS Group Research, Bloomberg as of 14 August 2015.

In Review

- **China** new yuan loans surged to CNY1.48 trillion last month, nearly twice as much as economists surveyed by Bloomberg News had forecasted. 60% of the loans, or CNY891 billion, went to financial institutions. Aggregate financing – or borrowing by businesses and households – slumped to CNY718.8 billion after it hit CNY1.86 trillion in June. Industrial output gained 6% on-year in July, below forecasts for 6.6%. Domestic demand held up, with retail sales rising 10.5% on-year. Fixed asset investments, a key economic driver, climbed 11.2% in the first seven months of 2015, the slowest pace since 2000.
- Consumer inflation in **India** eased to an eight-month low of 3.78% on-year in July. Inflation is now below the central bank's 4% goal, boosting hopes for a rate cut soon. Elsewhere, industrial output rose 3.8% on-year in June as manufacturing production recovered. Output for durable goods soared 16%, suggesting that demand is improving. Wholesale inflation fell to -4.05% on-year in July. This was the steepest decline in 10 years and is more than forecasts for -2.9%.
- The Bank of **Korea** (BOK) kept its policy rates unchanged to monitor the economy's recovery after the rapid spread of the Middle East Respiratory Syndrome (MERS) dented customer sentiment. BOK Governor Lee Ju-yeol said South Korea was prepared to tackle global financial market volatility and its impact on the domestic economy".
- **Malaysia's** economy is running at its slowest pace in almost two years. GDP grew at a rate of only 4.9% on-year in 2Q-15. A new goods and services tax, introduced in April, curbed private spending. Bank Negara Malaysia Governor Zeti Akhtar Aziz believes the economy will remain on a steady growth path and expects GDP to grow between 4.5% and 5.5% this year.
- Policymakers in the **Philippines** left its benchmark rates unchanged in a widely expected move. Bangko Sentral ng Pilipinas (BSP) Deputy Governor Diwa Guinigundo said he would monitor global conditions, especially currency volatility. He added the BSP wanted a stable currency market and would be ready to intervene to limit volatility.
- **Japan's** GDP contracted 1.6% on-quarter in 2Q-15 after two straight quarters of growth and was less than a 1.8% contraction that had been forecast. The Japanese economy was hit by weaker spending by consumers and businesses. This highlighted the struggle Prime Minister Shinzo Abe faces in his attempt to boost Japan's recovery.
- **Singapore's** non-oil domestic exports (NODX) declined 0.8% in July despite expectations of a flat growth figure. NODX were hurt by weaker non-electronic exports and slower shipments to top markets Japan, Taiwan, and China. The government had cut its NODX forecast last week to between 1% and 2% for the full-year of 2015. Retail sales jumped 6.9% on-year in June. This was due to stronger motor vehicle sales. Excluding that, sales shrank 3% on-year.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 17 August 2015.

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