Asia Pacific economy

Interest rate update: Heightened risks

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Philip Wyatt, Economist, philip.wyatt@ubs.com; **Valerie Chan**, Analyst, valerie-yt.chan@ubs.com; **Dominic Schnider**, CFA, CAIA, Analyst, dominic.schnider@ubs.com

- Recent developments in the US-China trade spat raise the risk that economic growth in Asia will fail to meet our 12-month expectations. As uncertainties have risen, we believe policy responses may be expedited to cushion the economy.
- For most of Asia, we have reduced our long bond interest rate forecasts by about 10–20bps to account for the potential growth drag. For Hong Kong 3-month HIBOR, we still expect spreads to widen to about 50bps, before trading at parity to the US.
- With the search for yield continuing, we believe India and Indonesia remain attractive, and continue to advise investors remain long local India and Indonesia 10 year bonds.

Our View

We see the most recent US-China trade escalation increasing the risk of a worst-case economic slowdown globally. Therefore, we have lowered most of our regional rates forecasts by about 10–20bps since our last update *(see report* "Interest rate update: Policy easing underway" *dated 22 August)*. Economic growth in Asia slowed to a crawl in 2Q, but there is a risk of a further step down if the US-China trade conflict intensifies.

What is changing is the urgency to ease policy more aggressively in Asia – we expect 25–50bps of cuts in 2H19 for Korea, Indonesia, India, Malaysia, the Philippines, while another 75bps by mid-2020 for the US. The risk is that yet slower economic growth and easier US monetary policy induce deeper cuts. Fiscal policy is another lever, and is likely to have the most traction in faster-growing EM Asia.

Ten-year US Treasury yields declined another 60bps between mid-July and end-August. But the knock-on decline in local long yields in Asia is showing fatigue. In fact, the Asian local bond yields that trade at a discount (i.e. Korea, Taiwan, Thailand, Singapore, Hong Kong) have seen their spreads to US yields narrow. Meanwhile, the spreads of higher-yielding government bonds, excluding the Philippines, have moved up slightly, reversing some compression earlier in the year.

We think this is explained partly by the lag in industrial slowdown – Asia slowed earlier than the US – and partly by the fact that local economic fundamentals have not changed and industrial production is no longer deteriorating. Indeed, the US's new round of prospective tariff hikes in stages could generate some short-term lift in production via front-loaded exports.

Table 1: UBS APAC & US interest rate forecasts
APAC 3-month and 10-year rates, yield in % and CPI inflation in % y/y

		Inflation				6m forecast		12m forecast	
		3mma	Year-end		Latest	Old	New	Old	New
Australia	AU	1.3%	1.6%	3m	1.0%	0.8%	0.8%	0.7%	0.7%
				10Y	0.9%	1.0%	**0.9%**	1.1%	**1.0%**
New Zealand	NZ	1.5%	1.6%	3m	1.2%	0.5%	0.5%	0.5%	0.5%
				10Y	1.1%	1.2%	**1.1%**	1.3%	**1.2%**
Japan	JP	0.8%	1.2%	3m	-0.1%	-0.1%	-0.1%	0.0%	0.0%
				10Y	-0.3%	-0.1%	-0.1%	0.0%	0.0%
China	CN	2.7%	3.1%	7D repo	2.7%	2.4%	2.4%	2.4%	2.4%
				10Y	3.1%	2.9%	2.9%	3.1%	3.1%
Hong Kong	HK	3.1%	3.0%	3m	2.3%	2.1%	**2.3%**	1.6%	1.6%
				10Y	1.1%	1.3%	**1.1%**	1.6%	**1.4%**
India	IN	3.1%	3.8%	3m	5.4%	5.1%	5.1%	5.1%	5.1%
				10Y	6.6%	6.4%	**6.3%**	6.4%	**6.3%**
Indonesia	ID	3.3%	3.7%	7D repo	5.5%	5.0%	5.0%	5.0%	5.0%
				10Y	7.3%	6.8%	**6.7%**	6.8%	**6.7%**
South Korea	SK	0.7%	1.5%	3m	1.5%	2.1%	2.1%	2.4%	2.4%
				10Y	1.2%	1.6%	1.6%	1.6%	1.6%
Malaysia	MY	1.1%	2.4%	3m	3.4%	3.0%	3.0%	3.0%	3.0%
				10Y	3.3%	3.2%	**3.1%**	3.2%	**3.1%**
Philippines	PH	2.7%	1.8%	3m	4.0%	3.3%	3.3%	3.3%	3.3%
				10Y	4.4%	4.3%	**4.2%**	4.3%	**4.2%**
Singapore	SG	0.6%	1.5%	3m	1.9%	1.6%	1.6%	1.6%	1.6%
				10Y	1.7%	1.8%	**1.7%**	1.8%	**1.7%**
Taiwan	TW	0.7%	2.0%	3m	0.7%	0.7%	0.7%	0.5%	0.5%
				10Y	0.7%	0.6%	0.6%	0.6%	0.6%
Thailand	TH	1.0%	1.3%	3m	1.6%	1.8%	1.8%	1.8%	1.8%
				10Y	1.4%	1.6%	**1.5%**	1.6%	**1.5%**
US	US	1.8%	1.4%	3m	2.1%	1.8%	1.8%	1.6%	1.6%
				10Y	1.5%	1.8%	**1.6%**	1.9%	**1.7%**

Source: CEIC, Bloomberg, UBS, as of 30 August 2019

N.B.: China 7-day repo uses DR007 on average basis.

Related publications:
- APAC economy: The latest round of tariff escalation, 26 August 2019
- APAC economy: Interest rate update: Policy easing underway, 22 August 2019
- APAC economy: Macro monthly: Hong Kong, 19 August 2019

Source: UBS, as of 30 August 2019

The global "search for carry" is still in vogue, and in Asia it is best expressed by the yields on offer in Indonesia and India. Spread re-compression, in our view, should cause 10-year spreads to decline by 80bps to about 500bps in Indonesia and by 40bps to about 460bps in India. This reflects expectations for upcoming monetary easing, which is likely to be most generous in these economies.

In contrast, the likely fall in local government bond yields that trade at a discount to US (Taiwan, Korea, Hong Kong, Thailand) should be less given the comparatively reduced scope for monetary easing and the potential for an IT-driven lift in activity over next 12 months. For Hong Kong, we retain our outlook for the 3-month HIBOR-LIBOR spread to reach a 50bps premium (i.e. 3-month HIBOR at 2.3%) over six months given the heightened uncertainties, but note that severe spikes tend to be short-lived due to Hong Kong's strong balances. We have lowered our forecasts for the Hong Kong 10-year government bond yield to 1.1% in six months and to 1.4% in 12 months, trading at a discount of 50bps versus the US in six months before moderating thereafter.

In China, we keep our bond yield forecasts unchanged at 2.9% in six months and at 3.1% in 12 months. More policy support looks imminent and as the easing efforts come through they should eventually push up long yields over time.

In Singapore, we maintain our SIBOR forecasts at 1.6%, which incorporate our expectations for further Fed easing, and that spreads should narrow as the MAS eases further to a flat slope by end-April 2020. The long rates in Singapore, Thailand and Malaysia should inch further lower with increasing pressure globally, in our view.

Appendix

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