NOTE

SCB Economic Intelligence Center

Is the J-curve effect coming back?

10 July 2019

Unlike in April 2017, the cut in bond issuance in early July 2019 was not officially announced by BOT as a program and not large enough to result in the falling outstanding bonds. We, thus, believe that J-curve is unlikely to occur unless the BOT cut its bond issuance large enough to result in falling BOT bond outstanding. On policy rate outlook, while we maintain our view on a flat policy rate, we foresee a rising chance of a 25 bps rate cut in 4Q19F if 2019F GDP shows signs of falling below 3%. We expect pressure on Thai bond yields and Thai baht to continue and hence revise our year-end forecasts of 1-year bond yield to 1.65%-1.75%, 10-year bond yield to 1.9-2.0%, and USDTHB to 30-31.

Maintain our view on a flat policy rate but foresee a downside risk on a policy rate cut if 2019F GDP below 3%.

Before discussing our view on the J-curve effects (the situation when the short-term bond yields, such as 3-month, 6-month, or 1-year maturity are significantly lower than the policy rate, which is 1-day repurchase rate), we would like to start with our view on the policy rate. While showing some concerns on global economic slowdown and trade tensions, the Monetary Policy Committee (MPC) expects the economic recovery in 2020F and continue to believe that there remained a need to address financial stability risks. With a lower real policy rates compared to regional peers, EIC believes that the MPC has a smaller policy space and hence less likely to follow their regional counterparts in cutting its policy rate in 2019F. However, our recent 2019 GDP forecast (3.1% vs 3.3% by the MPC) heavily hinges on the assumption that no further tariff escalation in 2H19F. **In our scenario analysis, if the tension escalates, 2019F GDP growth is likely to fall below 3% and hence we foresee a 25 bps rate cut in 4Q19F.**

EIC expects policy rate to remain on hold this year, but foresee higher downside risk on rate cut if 2019F GDP falls below 3%.

Factors contributing to flat policy rate

Growth

- MPC expects Thai economy to expand at 3.3% this year, slightly below potential rate
- MPC forecasts the economic growth will rebound to 3.7% next year.

Financial Stability

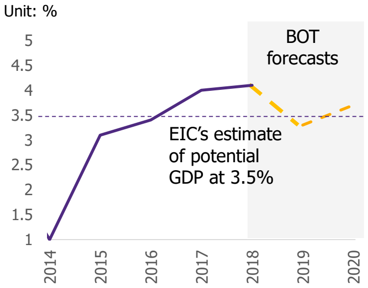
- If the economy slowdown further, NPL of SME and consumer loan might surge.
- However, rate cut could bolster household debt and search-for-yield behavior.

Real policy rate

- Thailand's real policy rate is among the lowest among regional countries.
- Hence, MPC has a smaller policy space and less likely to cut rate.

GDP growth

Unit: %



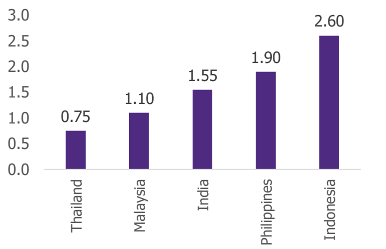
NPL to total loan, and Household debt

Unit: % of total loan

	2017	2018	2019Q1
Total Loan	2.91	2.94	2.94
SME Loan	4.37	4.46	4.60
Consumer loan	2.68	2.67	2.75
- Auto	1.60	1.66	1.71
- Housing	3.23	3.25	3.35
- Credit card	2.61	2.34	2.67
Household debt to GDP	78.3	78.6	78.7

Real policy rate of selected countries

Unit: %



The return of the J-Curve effect? In our view, three key factors leading to the J-curve effect in mid-2017 include 1) rising markets' expectation on MPC's rate cut, 2) persistent and significant strengthening THB against peers which prompts non-resident investors to speculate in Thai government bond market, and 3) falling BOT bond outstanding. As widely known, the program did not follow by the weakening THB against peers. In fact, THB started to depreciate mainly due to the rising dollar index (DXY) on the back of the hawkish Fed in 1Q18. Note that the appreciating THB took place a year after the start of the program and over the period when the BOT bond outstanding started to increase.

For the remaining of this year, J-curve is unlikely to occur unless the BOT cut its bond issuance large enough to result in falling BOT bond outstanding. Unlike in April 2017 when the BOT officially announced its bond supply cut program, resulting in the falling outstanding bonds, the cut in bond issuance in early July 2019 was not officially announced as a program and not large enough to result in the falling outstanding bonds. Among the 3 factors leading to the J-curve effect, we believe the first 2 factors are panning out. But, the third factor is not. We, thus, do not expect the J-curve effect to take place unless going forward the BOT bond issuance cut is large enough to result in the falling outstanding.

BOT bond issuance comparison between April 2017 and July 2019

	April 2017	**July** 2019
USDTHB situation before the bond issuance cut	+2.3% (March 2016 - March 2017)	+7.7% (June 2018 - June 2019)
Value of BOT bonds issued (per week)[1]		
• 3-**month bond**	30,000 million bath (Decreased by 10,000 million baht from the previous month)	35,000 million bath (Decreased by 5,000 million baht from the previous month)
• **6-month bond**	30,000 million bath (Decreased by 10,000 million baht from the previous month)	40,000 million bath (Decreased by 5,000 million baht from the previous month)
• **1-year bond**	45,000 million bath (No change from the previous month)	35,000 million bath (Decreased by 10,000 million baht from the previous month)
Change in BOT bonds outstanding[2]	Decreased by approximately 250,000 million baht (from the previous month)	Increased by approximately 65,000 million baht[3] (from the previous month)

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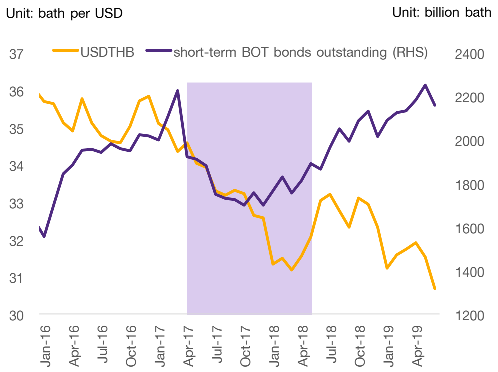
[1] 3-month and 6-month BOT bond will be auctioned 5 times in July 2019, while 1 year bonds are auctioned only 1 time per month.

[2] Calculated from the outstanding amount of BOT bonds with a maturity of less than 1 year, taking into account the amount of bonds expiring in that month without being renewed

[3] The outstanding value is calculated from 3-month and 6-month BOT bond to be issued in July 2019, minus the value of the 3-month and 6-month BOT bonds that will expire in July.

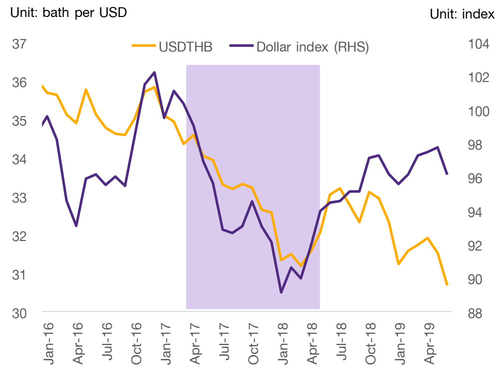
During the 2nd quarter of 2017, BoT cut its bond issuance in order to curb the speculative inflows toward Thai government bond market. The measure, however, were ineffective to weaken THB.

USDTHB and short-term BOT bonds outstanding



The measure was proved to be ineffective to curb THB strength. Despite BOT's effort to decrease bonds outstanding, THB has strengthened over time.

USDTHB and dollars index



The appreciation of THB was driven mostly by external factor, e.g. US dollars instead.

Source: EIC analysis based on data from Bloomberg and Thai BMA

EIC expects short-term Thai government bond yields to remain below policy rate slightly. J-curve is unlikely to occur again this year unless the BOT cut its bond issuance by substantial amount.

Short-term Thai government bond yields to remain below policy rate slightly

1 MPC to hold rate this year

Short-term yields are expected to hover around policy rate, given the MPC hold rate this year.

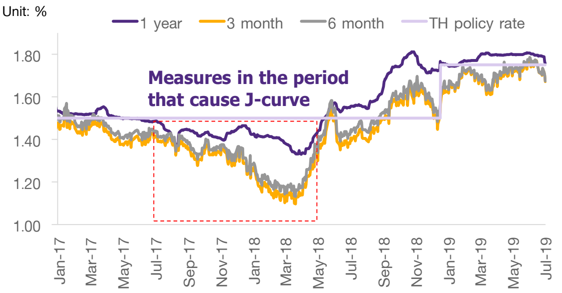
2 Price-in of policy rate cut

EIC expects that MPC would signal more dovish tone for the remaining of this year. This could result in the beginning of rate cut expectation.

3 Capital inflows

Capital flows toward Thai bond market could continue if uncertainty around trade war prolongs or US dollars weakens further.

Policy rate and short-term Thai government bond yields



Key factors leading to the J-curve

1. Rising MPC's rate cut expectation
2. Strong THB, prompting NR to speculate in TH govt bond market
3. Falling BOT bond outstanding

Source: EIC analysis based on data from Bloomberg and IIF

Pressure on Thai bond yields likely to continue. We revise down our forecast for 1-year bond yield at end-2019F to 1.65%-1.75% (vs 1.7%-1.8%). While we maintain our view on the flat policy rate throughout 2019, we expect slow GDP growth momentum and strong THB to raise markets' expectation on BOT rate cut in late 2019. Moreover, we also revise down our 10-year bond yield forecast at end-2019F to 1.9%-2.0% (vs 2.6%-2.8%) mainly to reflect the recent fall in 10-year Thai and US government bond yields, combined with our call on 2 Fed rate cuts in 2H19F on the back of US growth slowdown and lower inflation expectations.

Expect USD/THB movement of 30-31 for the rest of the year. We foresee strengthening pressure on Thai Baht to continue over 2H19 for three reasons. First, we expect US dollars to hover around the current level. This is because the dovish Fed, which usually weakens dollars, would be balanced by the slowdown in global economy, which creates demand for dollars. Second, Thai Baht status as a regional safe haven currency, supported by a large current account surplus (X% of GDP in 2018) and high reserves to short-term external debts (3.3X in 1Q2019). Third, compared with Thai MPC's stance, we foresee more dovish stance by the Fed and other regional central banks.

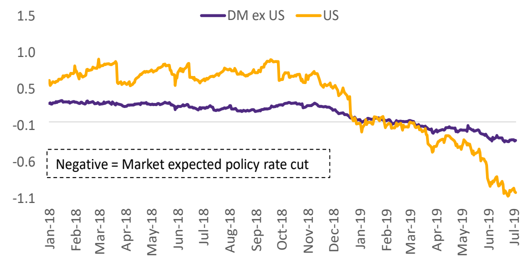
EIC revises down our forecast for USDTHB at end-2019 to 30-31 (from 31-32), for the given reasons

1) EIC expects US dollars to remain at the current range

Market expects Fed to be more dovish than other CBs

The difference between policy rate expectations and policy rate of DM countries

Unit: %

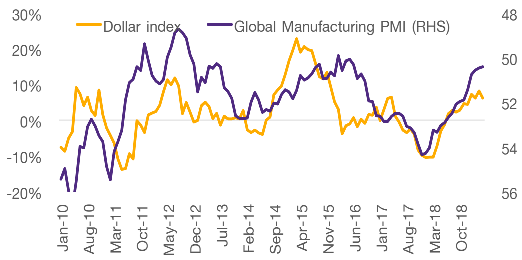


- Market expects that Fed could ease their monetary policy more than other major central banks as they have tightened the most in recent years.

Global economy is expected to slowdown

Dollar index and Global Manufacturing PMI

Unit: %YOY Unit: index



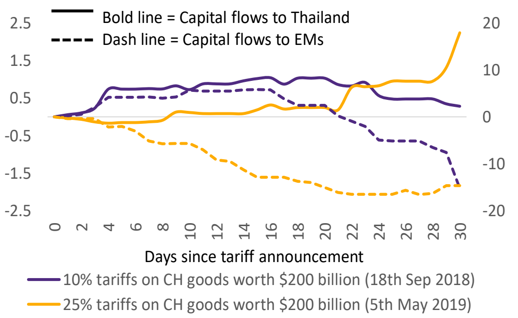
- Slowdown in the global economy would be the supporting factors for dollars (dollars smile trait).

Source: EIC analysis based on data from Bloomberg and JP Morgan

2) Capital flows toward TH during risk-off sentiment

Capital flows to Thailand and EM during risk-off

Unit: billion USD Unit: billion USD



- During the risk-off sentiment, capital outflows from EMs have been observed. However, Thailand has experienced with capital inflows because of the strong external stability.

Source: EIC analysis based on data from Bloomberg and IIF

3) Other regional CBs could ease their policy

FX change and policy rate of the countries in the region

	2018		2019		
	FX change (%change against USD)	Policy rate chg. (bps)	FX change (%change against USD)	Policy rate chg. (bps)	Policy rate (%)
US (DXY)	4.4%	100	0.6%	0	2.5%
Index	-8.4%	50	1.3%	-50	6%
Indonesia	-5.8%	175	1.8%	0	6%
Malaysia	-2.1%	25	-0.1%	-25	3%
Philippines	-5.1%	175	2.8%	-25	4.5%
Australia	-9.7%	0	-0.3%	-25	1.25%
New Zealand	-5.3%	0	-0.2%	-25	1.5%
Thailand	0.8%	25	5.2%	0	1.75

(Data as of 3 July 2019)

- In 2018, regional central banks have tightened their policy following the Fed. However, they are expected to ease further this year thus putting more strengthening pressure on THB.

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