MACRO | FX RESEARCH | Global

Maybank

31 May 2016

FX Monthly

2016, Issue V: Cautious Eye on the Fed and UK Referendum

Key themes[1]

- First, US Fed timeline for eventual future rate hike remains data dependent. US growth recovery remains on track but recent global developments out of China and volatile market activity may potentially affect the number of hikes in 2016. *Fed officials including Yellen are more hawkish recently.* Markets are now expecting 1 Fed hike in 2016; we are expecting 1-2 rate hikes by end 2016. *Key US events: ISM Manufacturing Mar (1 Jun) (expected: 50.4); US May NFP (3 Jun) (expected: 160k); Fed Chair Yellen to speak in Philadelphia (7 Jun); US-China Strategic Dialogue (6-7 Jun in Beijing); FOMC meeting, May CPI (16 Jun); May durable goods (24 Jun); 1Q GDP third print (28 Jun).*

- Second, Japan's 2% inflation target has been pushed back to 2H FY 2017 (by Mar 2018) due to oil softness and slow traction in wage increases. The credibility of Abenomics has waned somewhat in 2016 even though the easing bias is still clear. We do not expect any further moves by the BOJ until Jul meeting at the earliest and further jawboning is likely until then. Postponement of the consumption sales tax hike to Oct 2019 is now very likely, removing a likely drag on the economy. *PM Abe will hold a press conference on 1 Jun to announce his decision on holding simultaneous elections for both houses of parliament and on the sales tax hike in Apr 2017. BOJ policy board member Sato speaks in Kushiro on 2 Jun and BOJ deputy governor Nakaso speaks in Akita on 9 Jun and then again to the National Credit Union Association on 24 Jun. BOJ meets on 16 Jun to decide on policy. There is also the final print of 1Q 2016 GDP due on 8 Jun. JGB auctions in Jun: 10-year (2 Jun), 30-year (7 Jun), 5-year (9 Jun), 1-year (14 Jun) and 20-year (23 Jun).*

- Third, we *expect ECB to keep monetary policy stance status quo at the upcoming meeting (2 Jun) as ECB is determined to ease financing conditions, stimulate new credit provision in an attempt to reinforce growth momentum and return inflation to medium term objective of 2%. Front-end yield differentials between 2Y Euro and UST bonds widened and may weigh on Euro with some limits. Downside likely to be limited around 1.08 - 1.09 levels. ECB meeting, Apr PPI (2 Jun); 1Q GDP final (7 Jun); May CPI (16 Jun); Jun ZEW survey expectations (21 Jun); Jun confidence indicators (29 Jun).*

- Fourth, China still has excess capacity, heavily indebted corporations and huge liquidity injections continue to add immense pressure on the economy and the yuan medium term. *PBOC continues to rely on SLF, MLF and PSL as liquidity tools, we do not rule out interest rate cut of 25bps and RRR to be cut in intervals by another 100bps within the year. Activity indicators (i.e. urban investments, industrial production and retail sales) will continued to be eyed. May PMI-mfg is due on 1 Jun along with Caixin version. The China-US Economic and Strategic dialogue is scheduled on 6-7th. Foreign reserves and trade data are curiously scheduled for release on 7th and 8th respectively. CPI and PPI on the 9th. Activity data will be released on the 12th. Liquidity numbers are due from 10th-15th. We also like to watch Apr industrial profits due on the 27th. We also eye potential inclusion into MSCI and JPM bond indexes.*

- *We believe AXJs could see some weakness in 1H of Jun in the run up to the June FOMC. We could see initial broad USD strength in the lead-up to Jun FoMC and potential sell-off thereafter.*

[1] Underlined words represent new developments in the FX themes.

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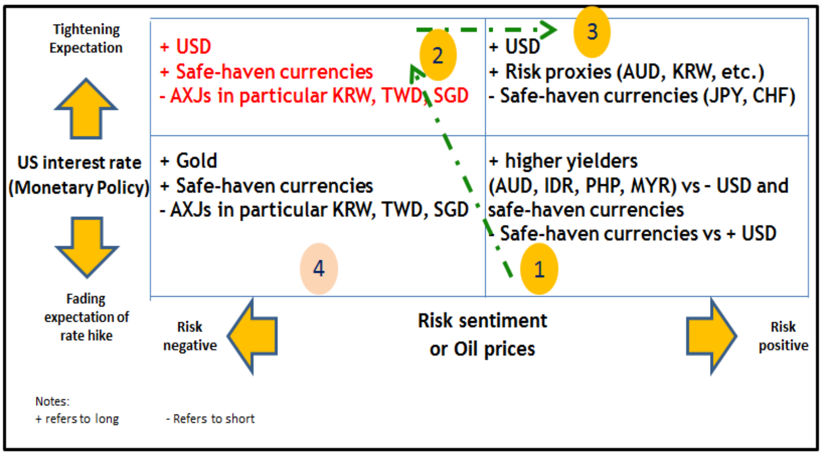
SEE PAGE 44 FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

So what?



- **Macro Themes:** We hold our view that Fed will raise target rate by 25bps on 17 Jun. Recent FOMC Minutes and somewhat hawkish comments by FOMC voters have already started to raise market 's expectations for a rate hike in Jun. Dollar rose above the 95-level at last sight. With Fed Fund Futures showing 30% of a Jun hike, the dollar tone should remain supported into Jun. Risk assets have so far weathered the rates adjustment well, with brent now above USD50-level and US equities up for the month so far. We anticipate a potential shift towards the right upper quadrant in the 2by2 grid shown above with dollar strength, likely capped beyond Jun.
- **Major Currencies:** UST curve still suggests that markets expect only 1 hike at most within the year but economic data still suggest that 2 hikes are not impossible. Put that together and USD could strengthen further. EU-UST bond yield differential may narrow post Fed hike, entailing upside risks for EURUSD. Elsewhere, the bold-hearted were rewarded for those who had bought the GBP on fear. Still, Brexit campaigners could fight back to swing opinion polls and that could mean more volatility before the referendum on 23 Jun. For AUD, RBA has acted decisively with a rate cut in the seasonally weak month for AUD and that has dragged the AUDUSD towards levels around 0.72. The Election Campaign into polling day could see more volatilities in the currency.
- **China:** CNY adjustment is not over but PBOC is likely to continue to keep yuan stable to stem capital outflows as the economy remains under pressure. Markets seem to be convinced of the central bank's ability to ensure yuan stability and downside pressure has eased significantly. We eye the moves of USD and the RMB index and look for rangy moves between 6.40-6.60 for much of the rest of 2016 with some upside risks in the near-term.
- We see USD retaining a firm tone into Jun FOMC (16 Jun), and hold our bullish USD view primarily against the Asian currencies. We think some of the AXJs (i.e. SGD, IDR, THB, INR) are more vulnerable to dollar upsides relative to their peers. In addition, the much-awaited UK-EU referendum will have its verdict on 23 Jun and we continue to look for opportunities to accumulate GBP on fear in the next couple of weeks. Risks to our view are a Brexit scenario that could potentially trigger a financial meltdown, sharp deterioration in China's growth, crude supply overhang that could drag on oil price and a Donald Trump Win.

G7 Global Overview

USD: A Month of Two Halves?

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USD Index	96.00 (96.42)	95.14 (97.53)	96.78 -	96.84 (97.16)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We wish to reiterate our out-of-consensus call for 25bps rate hike in Jun FOMC meeting (16 Jun 2am SGT). We caution that a continuous repricing of Fed hike in Jun, (due to market complacency over Fed rate hike trajectory) could continue to see UST yields higher in particular Treasuries 2y and below, and see **USD strength (buy the rumor) in the lead-up to the Jun FOMC** meeting. We believe the **USD could be broadly supported leading into D-day** but we do not rule out "buy the rumor (USD), sell the fact (USD)".

- Recent economic data including home sales, retail sales, consumer sentiment, durable goods orders have been consistently firmed and most importantly, labor market at or near full employment and inflation progressing towards Fed's medium term objective of 2% further warrant room for for Fed to raise rates. We continue to warn that markets remain complacent with Fed rate hike trajectory and could still be underpricing it. Recent Fed rhetoric (12 May) also seem to suggest that the Fed thinks markets could be complacent. **Fed's Rosengren said "market remains too pessimistic about the fundamental strength of the US economy and the likelihood of removing monetary accommodation is higher than is currently priced into financial markets** based on current data"; Fed's George said "moving rates to a more normal level and at a gradual pace is necessary to minimise distortions"; Fed's Mester said "support a gradual adjustment of short term interest rates towards a more normal level but viewed the current level (of rates) as too low for today's economic conditions". FOMC Apr minutes (19 May) noted **"Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June"**. And most recently (27 May), Fed Chair Yellen said that ***"… appropriate for the Fed to gradually and cautiously increase interest rate over time, probably in the coming months…"***

- We do observed there have been ongoing adjustments with regards to Fed rate hike expectations - Implied probability of Fed hike in Jun, Jul inched higher to 30% and 53.8%, respectively from 4% and 26%.

- However we **do not expect the Fed rate hike to trigger a big sell-off in risk assets as Fed is expected to reiterate a gradual pace of tightening.** Moreover we see the **rate hike as a testament to US economy's progress towards recovery,** which **should keep risk sentiment cautiously supported** (which has been the case over the past 2 weeks or so) and **see risk proxies including equities holding on to gains and AXJs retracing some of its losses (hence *sell* the fact post FOMC meeting).** This is conditional on the FOMC statement and projection that we are closely watching – and we expect the Fed to acknowledge that recent economic data remains relatively resilient, continues to reiterate gradual and cautious pace of tightening; economic/inflation projection to be largely unchanged from previous quarter's projection; dots plot to continue signaling at least another rate hike this year (assuming Fed hikes in Jun).

- Therefore we think Jun could turn out to be **a month of 2 halves as USD stays supported into FOMC meeting but turns softer following the rate hike in Jun.** This is consistent with the Dec 2015 hike eipsode which saw USD broadly higher against most currency pairs into Dec 2015 FOMC meeting and subsequently retrace gains.
- **Growth and Inflation Outlook**: The second read of **1Q GDP was revised higher to +0.8% saar. (from +0.5%) but slightly below consensus of +0.9%.** The headline upward revision was driven by inventories, residential investment and exports while private consumption held steady at +1.9%.
- In the Mar FOMC, Fed's forecasts for US GDP growth and inflation rate for 4Q 2016 were trimmed to 2.2% annual rate (from 2.4% annual rate) and 1.2% YoY from 1.6% YoY respectively, although the unemployment rate forecast remain at 4.7%. Fed maintained its view that the economy is expanding at moderate pace; household spending, are increasing at solid rates and housing sector continues to improve while business investment and net exports have been. The next FOMC projections will be released on 16 Jun.
- **US Apr CPI recorded their biggest increase in more than 3 years.** On m/m terms CPI jumped +0.4% (vs. +0.1% in Mar). On y/y terms, CPI was up 1.1% (vs. +0.9% in Mar). The rise was led by medical, food, recreation, tobacco, transport. Core inflation increased 2.1% y/y in Apr. Fed's preferred measure of inflation - PCE core inflation was at 1.6% y/y in Mar.
- While inflation continued to run below the 2% longer-run objective partly reflecting declines in energy prices and in prices of non-energy imports, there are more signs that price pressures are picking up and could give room for Fed to hike as early as the next meeting in Jun.
- **Monetary Policy Forecast:** FOMC minutes for Apr meeting (released on 19 May) suggested with a bit more market conviction that FOMC meeting in Jun is "live". This is in line with our caution that markets could potentially be under-pricing Fed hike trajectory and a shift in expectation could lead to ongoing readjustment (which has already begun in May) and could lead to higher UST yields and USD strength. The key takeaway from the minutes was "**Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's 2 percent objective, then it likely would be appropriate for the Committee to increase the target range for the federal funds rate in June**".
- Fed Chair Yellen's comments (27 May) **reiterated that economy continues to improve (while acknowledging weak growth in 1Q and relatively weak growth at the end of 2015). She again**

emphasized that if growth and labor market continue to improve, it is appropriate for the Fed to gradually and cautiously increase interest rate over time, and probably in the coming months for such a move would be appropriate. The last part of the sentence probably “excited” the markets.

- Implied probability of rate hike (from fed fund futures) in Jun has jumped to 30% (from 4% in end-Apr/early-May). It remains our view that recent data out of US economy (in particular labor market report, inflation reading) have been constructive and supports the case for a rate hike. These further **reinforced our earlier call for Fed to hike rates twice this year - once in Jun and another one in Dec.** We do note that markets are pricing in a larger probability of a rate hike in Jul (as implied from Fed fund futures) at 53.8% (vs. 26% in end-Apr/early-May).
- At the last FOMC meeting in Apr, Fed kept the target fed funds rate (FFR) unchanged at 0.25%-0.50% for the third consecutive FOMC meeting in Apr 2016 after the 25bps hike at Dec 2015’s FOMC meeting.
- **Latest Fiscal and External Balance Outlook:** Fiscal sustainability risk continues to weigh on the outlook and may emerge after the Nov 2016 presidential election. In the long term, an improved US economy and manufacturing sector, US shale oil and gas production may improve the US current account leading to dollar support but this is likely to be long drawn and may probably begin only in 2017/2018.
- **Key domestic events and issues to watch in Feb 2015:** ISM Manufacturing Mar (1 Jun) (expected: 50.4); US May NFP (3 Jun) (expected: 160k); Fed Chair Yellen to speak in Philadephia (7 Jun); US-China Strategic Dialogue (6-7 Jun in Beijing); FOMC meeting, May CPI (16 Jun); May durable goods (24 Jun); 1Q GDP third print (28 Jun).
- **Technical Outlook:** Technical signals bullish bias in the short-term - 21 DMA cuts 50 DMA to the upside while daily, weekly momentum continues to indicate a bullish bias. This suggest that DXY could remain supported. Resistance at 96-levels (100 DMA, 50% fibo retracement of 2016 high to low) before 96.80 (200 DMA, 61.8% fibo). But we are cautious of stochastics at overbought conditions which could suggest that upside may be limited and could be due for a move lower. Support at 94.60 (21, 50 DMAs) before 93.78 (23.6% fibo).

EUR: Remains Driven by Monetary Policy Divergence

Forecast	2Q 2016	3Q 2016	4Q2016	1Q 2017
EUR/USD	1.1300 --	1.1500 (1.1100)	1.1200 --	1.1100 --

No Change from Previous Forecast

- **Motivation for the FX View:** The theme that we highlighted in our May Monthly Outlook – *“monetary policy divergence back in focus”* has continued to guide us well as EUR/USD continues to be driven by front-end yield differentials between 2Y Euro and UST bonds. We see EUR downside pressure leading into Jun FOMC (our base case remains for Fed to hike in Jun). Downside likely to be limited around 1.08 - 1.09 levels. We expect EUR to retrace its initial weakness post-FOMC retracement into end-Jun. Expect choppy month as positions adjust amid thin liquidity; range of 1.08 – 1.15 expected.

- 2Y Yield spreads have widened from -120bps in early-Apr to -135bps in late Apr (EURUSD fell from 1.1450 to Apr-low of 1.1220). Yield spreads then narrowed into early-May (from -135bps to -122 bps) which then saw EURUSD rising to 2016-high of 1.1616. Since early-May, **yield spreads begun to widen again (driven by renewed talks of possible Fed hiking interest rate sooner than expected) from -122bps to -142bps. This subsequently saw EURUSD falling to 1.1098 low** at time of writing (30 May). **Continued focus on monetary policy divergence is expected to remain in focus as we head into US FOMC meeting in Jun.**
- Yield spreads (currently at -142bps; UST at +91bps; EU bonds at -51bps) can widen further possibly driven by higher 2Y UST yields (2Y UST was as high as 1.09% in Dec 2015 when Fed hiked) into Jun FOMC (assuming if Fed hikes) and this **widening in yield spreads have the potential to depress EUR further.** Looking back at episodes of yield spreads widening (based on simplistic observation in Apr-May 2016) - when **yield spreads widened by about 15 - 20 bps, EUR tend to fall by 250 - 300 pips.** With EUR at 1.1120 at time of writing as reference, EUR could potentially move lower towards 1.0820 if spreads widen by as much as 20bps towards Jun FOMC meeting. But we think there is a limit to how much the spreads could widen and hence limited downside on EUR.
- But we also observed an **asymmetric relationship when yield spreads narrow - when yield spreads narrowed by 15 - 25bps, EUR tend to rise more by 250 - 470 pips** (based on past 3 months simplistic observation assuming no market distortion).
- We believe **post-FOMC rate hike could see USD and UST yields easing** (base case assumption: Fed remains on gradual path of tightening; FOMC dots projection remains unchanged; ECB no change to monetary stance), and **this could lead to potential narrowing of yield spreads in the second half of Jun and lead to an eventual retracement of EUR losses.** (This is on assumption that Fed hikes in Jun and maintains gradual pace of rate hike trajectory).
- Technical suggests next support at 1.11 (200 DMA, upward-sloping trend line support from lows of Dec 2015 and Mar 2016) before 1.1070 (50% fibo retracement of Dec low to May high). Break below that exposes the pair towards further downside at 1.0940 (61.8% fibo). We think there is scope for EUR to venture lower first before turning higher as stochastics are at oversold conditions.
- We **keep our FX forecast over the forecast horizon but adjusted EUR higher for 3Q**, to take into account possible USD weakness post-FOMC hike.
- **Growth and Inflation Outlook: Euro-area 1Q GDP grew 0.5% q/q** (vs. 0.6% initial estimate) but still an improvement over 4Q 2015 which saw growth of only +0.3% q/q. Stronger growth in 1Q was driven by Germany, Spain and France. Euro-area composite PMI was a touch softer in Apr (53.0 vs. 53.1 in Mar); services PMI held

steady at 53.1 while manufacturing PMI was a touch firmer (51.7 vs. 51.6 in Mar). Euro-area Mar industrial production, on the other hand, fell (-0.8% m/m).

- Economic recovery (backed by private consumption) in the Euro-area continues but has yet to recover back to pre-GFC levels. Looking ahead domestic demand should continue amid accommodative monetary policy support, recent credit easing support, earlier progress made with fiscal consolidation and ongoing structural reforms. Low oil prices, weaker EUR and still accommodative monetary conditions should continue to provide support for private consumption. ECB expects GDP to rise by 1.4% in 2016, 1.7% in 2017 and 1.8% in 2018. The next set of forecasts will be released on 2 Jun.

- **Euro-area inflation is expected to remain near zero or even slip into negative territories amid lower energy prices.** ECB expects inflation to recover into later part of 2016, supported by ECB measures and economic recovery. Apr headline inflation ticked down to -0.2% y/y (vs. 0% in Mar), driven by recreation and culture. Core inflation was steady at +0.7% in Apr. Looking ahead we expect inflation to remain subdued for most part of the year and only gradually pick up from end-year off the back of oil prices stabilizing, and continued pick-up in demand.

- **Monetary Policy Forecast:** We **expect ECB to keep monetary policy stance unchanged at its upcoming meeting on 2 Jun** – keeping rates unchanged as at last adjustment in Mar and keeping all parameters of the QE unchanged (see below).

- In ECB minutes (released in Apr), ECB noted that the *announcement of the €20 billion increase in monthly purchases, to €80 billion, under the asset purchase programme (APP) and of the new corporate sector purchase programme (CSPP) had led to* ***sizeable changes in investors' positioning****.* ***Some compression of intra-euro area government bond spreads had subsequently been observed amid a generally positive impact on yields****. The ten-year German government bond yield had declined to within a few basis points of its all-time low, observed in April 2015. European corporate bond spreads had seen a general repricing. The* ***narrowing of spreads had extended beyond the market segments expected by market participants to be eligible for the CSPP - notably, spreads on sub-investment grade bonds had also narrowed considerably****. Exposure to corporate risk had increased. Position-taking in European credit default swap (CDS) indices for corporate bonds had more than doubled since the ECB's announcement of the CSPP. A possible reason was that the CDS market for corporate bonds could also be used to hedge some macro risks. Counterparties had furthermore reported that the CSPP announcement had also marked a noticeable improvement in corporate issuance. Issuance volumes and announcements of new deals had increased substantially in recent weeks, although they remained low overall compared with last year. More evidence and analysis was needed to fully understand the determinants of the supply side. The purpose of such issuance also remained to be understood, whether related to funding investment projects, M&A financing or liability restructuring. One feature had been that issuers were issuing more bonds with longer maturities.*

- Monetary policy is expected to remain accommodative for a prolonged period after recent move in Mar, where ECB eased on multiple fronts including cutting all key policy rate including the main refi to 0% (from 0.05%), marginal lending rate to 0.25 (from

0.3%) and deposit rate to -0.4%. ECB will also increase the monthly purchase by €20bn to €80bn per month (from €60bn previously). There were also technical adjustments being made to the QE program (i.e. introduce corporate sector purchase program, etc.) to strengthen the monetary and credit transmission.

- The objective of the corporate sector purchase program (CSPP) is to **strengthen the transmission mechanism of monetary easing (via bond purchase) on the financing conditions of the real economy.** Purchases will commence in Jun; carried out by 6 national central banks acting on behalf of the Euro system. **In combination with other non-standard measures, monetary policy will be eased further and help inflation return to 2% medium term target.** ECB will purchase eligible debt instruments (BBB- and above credit rating; minimum remaining maturity of 6m and maximum of 30y; denominated in EUR) from non-bank corporations incorporated in the Euro area even if the ultimate parent is not based in the Euro-area (as long as they fulfil all other eligibility criteria including issuer not a credit institution, not an asset management vehicle, etc.). A share limit of 70% per ISIN on the basis of outstanding amount will be applied. While this **non-standard easing is expected to ensure accommodative monetary conditions,** this may also lead to a flurry of bond issuance from foreign non-bank corporates.
- **Latest Fiscal and External Balance Outlook:** The government deficit ratio is projected to decline to 1.5% in 2017, from 2.1% of GDP in 2015. Projected government debt ratio is projected to decline gradually to 88.4% in 2017, from 91.5% of GDP in 2015.
- Euro-area current account surplus widened to EUR27.3bn in Mar from 19.2bn in Feb 2016. Cumulative 12-month current account surplus to GDP as of mar 3.1%, 4-month high.
- **Key domestic events and issues to watch:** ECB meeting, Apr PPI (2 Jun); 1Q GDP final (7 Jun); May CPI (16 Jun); Jun ZEW survey expectations (21 Jun); Jun confidence indicators (29 Jun).
- **Technical Outlook:** EUR has traded lower for the month of May. Last seen at 1.1130 levels. While daily momentum remains bearish bias, stochastics is at oversold conditions. Key support at 1.11 (200 DMA, upward-sloping trend line support from lows of Dec 2015 and Mar 2016) before 1.1070 (50% fibo retracement of Dec low to May high). Break below that exposes the pair towards further downside at 1.0940 (61.8% fibo). We think there is scope for EUR to venture lower first before turning higher. We think downside could be limited. Resistance at 1.12 (38.2% fibo), 1.1360 (23.6% fibo).

GBP: All Eyes on Referendum - 23 Jun

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
GBP/USD	1.4500 (1.4000)	1.4800 (1.4400)	1.4800 --	1.5200 (1.4800)

No Change from Previous Forecast

- **Motivation for the FX View:** In about less than a month to go, the UK will go to the polls (on 23 Jun) to vote whether to "Remain in EU" or to "Leave the EU". While we expect debate to intensify, we also observed that opinion polls (FT poll of polls) are swinging in favour of remain (47% for Remain and 40% for Leave) and betting odds suggest that most bets are placed on "Remain in EU". This remains in line with **our expectation for UK to vote to remain in EU** as the public is gradually becoming more aware of pros and cons of *Brexit*.
- As of writing (26 May), GBP has already turned higher (above 1.47-handle), in response to the swing in opinion polls, betting odds and comments from BoE Carney. In a recent testimony to parliamentary committee (24 May), he said the **next rate move is more likely to be up than down in a 'Remain' vote**, whereas the implications of a 'leave' vote would depend on the reaction of the exchange rate. **We still see GBP being caught up in 2-way directional swings in the lead-up to referendum day, with risk of further unwinding in GBP shorts resulting in possible upside risk. There could be a potential 'buy the rumor, sell on fact' post-referendum (23 Jun) which could see a pullback on GBP.**
- We are calibrating higher our FX forecasts for 2Q and 3Q to 1.45 (from 1.40) and 1.48 (from 1.40), respectively, taking into consideration the recent up-moves in GBP despite USD strength elsewhere. We also adjust 1Q 2017 forecast higher to 1.52, as we expect markets to start pricing BoE first rate hike. Markets have started to adjust their expectation earlier from 4Q 2017 to Jun 2017 (implied from 90-day futures).
- Technically speaking, further upside towards 1.4860, 1.50 could materialize on the break (on daily/weekly close basis) above 1.4770 (200 DMA and 2016 high). **We reiterate our fair value estimate for GBP is at 1.58.** The model takes into account yield differentials adjusted for inflation, current account differentials and a reflation variable. We still favour buying GBP, strategically on dips.
- **Downside risks to our view if UK votes to Leave the EU.** Then GBP could potentially break below its previous low of 1.3840 (2016 low) and test even lower beyond 1.33 (2 standard deviation away from fair value estimate) as markets react in response to uncertainty.
- **Growth and Inflation Outlook:** In the May Quarterly Inflation Report, BoE cut 2016 GDP forecast to 2% (vs. 2.2%) on signs that uncertainty relating to UK's membership on EU has begun to weigh on activity. Inflation forecast for 2016 remains at 0.4% but was lowered to 1.5% (from 1.6% in Feb's QIR). BoE's medium term inflation target remains at 2%, and expects inflation to return to 2% by the middle of 2018.

- Second estimate of 1Q GDP held steady at +0.4% q/q. On y/y basis, 1Q growth was revised marginally lower at 2% (from 2.1% in advanced estimates). Private consumption remains the main driver while business investment and external sector remain the main drag. On Apr PMI releases – manufacturing (49.2 vs. 51 prior), services (52.3 vs. 53.7 prior) and construction (52 vs 54.1) all slumped. Labor report was slightly better than prior month with job growth accelerating, unemployment rate steady at 5.1% and pick-up in weekly earnings.
- Both headline (+0.1% m/m vs. +0.4% prior) and core inflation (+0.3% m/m vs. +0.5% prior) disappointed to the downside in Apr, due to lower transport and clothing prices.
- **Monetary Policy Forecast:** A benign inflation outlook (at 0.4% y/y in Apr remains far from BoE's medium term target of 2%) and *Brexit* risks are expected to keep BoE on the sidelines for longer than expected. **Markets are now bringing forward their expectation for BoE's first rate hike to be sometime around Jun 2017 (from 4Q 2017).** This is likely due to a few reasons namely that ***Brexit* risks are slowly dissipating** and BoE Gov Mark Carney's recent testimony to parliamentary committee (24 May) that **a 'remain' vote would mean that the next move in interest rates would probably be up,** whereas the implications of a 'leave' vote would depend on the reaction of the exchange rate.
- In the previous BoE meeting on 12 May, MPC was unanimous to keep rate unchanged at 0.5% and asset purchase facility unchanged at £375bn. In the accompanying statement, BoE expects a further deceleration in activity growth in 2Q, due to *Brexit* fear. BoE Governor Carney warned that "A vote to leave the EU could have material effects on the exchange rate (to depreciate sharply), demand and supply potential," and said that the impact "could possibly include a technical recession.
- **Latest Fiscal and External Balance Outlook:** UK government's borrowing for the year to the end of Mar 2016 has been revised up by GBP2bn to GBP76bn. The OBR has initially expected only GBP72.2bn of borrowings. This means the government missed its forecast by more than initially expected (of about GBP3.8bn).
- UK's 4Q current account deficit widened to record levels of 7% of GDP since data collection began in 1955. This was due to drop in exports and a rise in imports, large increase in primary deficit (lower returns to UK from investment abroad).
- **Key domestic events and issues to watch:** A very busy week on 3rd week of Jun which sees May CPI/PPI (14 Jun), labor report (15 Jun), retail sales and BoE meeting (16 Jun), coinciding with FoMC meeting in US. 1Q GDP (final) to be released on 30 Jun.
- **Technical Outlook:** May was a month of 2 halves for GBP. We expect choppy and wild price action to continue in the lead-up to referendum day (23 Jun). Weekly momentum remains bullish bias - favor buying on dips looking for a move beyond 1.4755 (200 DMA), 1.4880 (50% fibo retracement of 2015 high to 2016 low), 1.5130 (61.8% fibo). Area of support at 1.4340 (100 DMA) – 1.44 (50 DMA).

AUD: Range Trading Shifts Lower

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
AUD/USD	0.72 (0.78)	0.70 (0.75)	0.72 (0.78)	0.70 (0.75)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** AUDUSD broke the 0.72-level as we write on 24 May and waffled around the mid-0.71 thereafter. May has been a month of weakness for the AUDUSD as we had expected, but we did not foresee the rate cut that RBA delivered on 3 May. With that rate cut, RBA became the worst performer amongst the G10 currencies for May. Given soft China outlook, election uncertainties into Jul (Federal Elections on 2 Jul), potential fiscal slippage that could result from a fierce election campaigns which could have concomitant negative impact on its AAA credit rating, USD resurgence as well as expectations for further rate reduction, the AUDUSD is likely to head lower towards the 0.70-handle before the year low of 0.68.
- Household consumption continues to be underpinned by strong hiring sentiments, low interest rates, and cheaper oil prices. Over the past few months, cheaper AUD has boosted Australia's tourism and education. Recent rise in commodity price has left the term of trade relatively unchanged. With oil seemingly finding stability in the near-term, first support for the AUD is seen at 0.68. Range-trading is likely shifted lower from 0.72-0.78 to 0.68-0.75.
- **Growth and Inflation Outlook:** High frequency data was mixed for May. Commodity index improved slightly to 87.0 in Apr from previous 86.6. NAB business conditions deteriorated to 9 from 12 previously while that of business confidence slipped to 5 from 6. According to the report by NAB, the results of the Apr survey indicated retracements from that seen in Mar but responses indicate a "favorable business environment". This suggests that RBA has lowered cash target rate as inflation offers more scope. The impact on AUD could lend support to price pressures via the tradables component as well as to spur the growth momentum of the services trade sector.
- Apr offered another mixed labour report. While the net hiring rose by 10.8K, that was a result of part time employment rising by 20.2K that offsets the 9.3K fall in full time employment. Jobless rate steadied at 5.7%. Wage growth softened to 0.4%q/q in 1Q from the previous 0.5%. Year-on-year, the pace decelerated to 2.1% from previous 2.2%. Slower wage growth is due to structural rebalancing of the economy as workers shifted from higher paying resource related jobs to lower paying jobs in non-mining sector. Interestingly, the slower wage growth in the last quarter did not temper consumer sentiments for May which jumped to 103.2 from 95.1. Retail sales also accelerated more than expected to 0.4%m/m in Mar from a 0.1% growth in Feb.
- Credit growth keeps pace, capacity utilization extends its uptrend its for Apr, strong tourist arrivals, visitor spending and cheap AUD should continue to support the retail sales.

- 1Q Capex fell 5.2%q/q, undershooting the already weak expected -3.5%. The quarter-on-quarter fall in business expenditure was not unexpected. The second estimate for the 2016-2017 expenditure rose from the first estimate to A$89.231mn. However, this estimate is still lower than that made in the same period last year for 2015-2016. The fall is mainly due to the decline in planned expenditure in the mining sector. However, the same cannot be said for the manufacturing and other selected industries which saw higher estimated business expenditure for 2016-2017 compared to the same estimate made for 2015-2016. Economic rebalancing is still progressing at a slow pace.
- **1Q CPI surprised to the downside with a print of -0.2%q/q, undershooting the consensus of +0.2%.** In addition, the trimmed mean measure of CPI, taken by the RBA as core inflation, decelerated to 0.2%q/q from the previous 0.6%. Year-on-year, the trimmed mean slowed to 1.7% from previous 2.1%. Weakened price pressures were observed with the heavily weighted food component declining -0.2%q/q as well as that of Recreation and culture which fell -0.1%. Housing rose 0.3%q/q.
- **Monetary Policy Forecast:** RBA cut cash target rate by 25bps to 1.75%, much to our surprise as well as to many in the market. Inflation was highlighted as a key source of uncertainty and tighter macroprudential lending standards also allowed the central bank to send rates lower. More recently, outgoing RBA Governor Glenn Stevens even defended the central bank’s inflation target band of 2-3%. In the Statement of Monetary Policy, the central bank highlighted that the domestic cost is a key source of uncertainty. In addition, the exchange rate is a significant source of uncertainty for the forecasts of inflation, as well as for the outlook for growth in activity. Given the exchange rate’s integral role as “shock absorber” for the economy, we think that RBA acted as backstopper for AUD lest its continued strength undermines the growth of the services sector and add further downside pressure on inflation.
- Going forward, we see risk of another rate cut in August as inflation is likely to remain subdued. With Aug the other seasonally weak month for the AUD, the timing could give RBA most bang for its buck. In addition, upside extension in oil prices could translate into higher base metal prices given the correlation between oil and the rest of the commodities which should in turn, give AUD a lift. AUDUSD is also susceptible to rate hike expectations. If the Fed were to deliver another dovish hike in Jun/Jul, expect risk on rally to ensue and provide even more support to the AUD. With the next Statement on Monetary Policy also due in Aug, we see risks of a cut in Aug which is a convenient time for RBA to deliver the last cut for the year before another extended pause.
- **Latest Fiscal and External Balance Outlook:** The budget deficit for 2016 is expected to be A$37bn. The deficit is projected to exist for the next four years. The government expects to raise tax on tobacco and commit a record A$50bn in infrastructure investment between 2013-14 and 2019-20 for roads, rail, airports and dams. Fiscal deficit is estimated to be around -2.2% of GDP for 2016-2017 before gradually narrowing towards -0.1% by 2019-20. Real GDP is estimated to be 2.5% this year before accelerating to 3% for the next 3 subsequent fiscal years. One of

the key plans is the Ten Year Enterprise Tax Plan meant to boost new investment, create and support jobs ad increase real wages. The Plan will see lower tax rates for small businesses first before progressively extending cuts to all companies by 2026-27. For personal tax, the government will also lift the tax threshold on the middle tax bracket to prevent average full time wage earners from moving into the second top tax bracket. This could serve to boost consumption in the long run.

- Current account deficit widened to -A$21.1bn 4Q from previous -A18.8bn in 3Q (last available data).
- **Key domestic events and issues to watch:** 1Q GDP due on the 1st. Apr trade is due next on 2nd followed by May inflation estimates. RBA decides on cash target rate on 7th Jun. Home loans for Apr due on the 8th. NAB business surveys for May will be released on the 14th before labour report for May on 16th. Minutes of the May meeting is due on the 21st. Federal elections is scheduled on the 2nd of Jul.
- **Technical Outlook:** Technical indicators have been very mixed but we like to lean on trend more than momentum indicators at this point. Whilst the daily chart flagged oversold positions for the AUDUSD, the weekly chart is a lot more bearish on this pair. Near-term rebounds to meet barrier around 0.7328 (2015-2016 rally). Pullback to meet support at 0.7064 first before our eventual target at 0.68. Should that level hold, we anticipate a strong double bottom.

NZD: Retain Bearish Outlook; Still a Sell on Rally

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
NZD/USD	0.6650 (0.6800)	0.6600 --	0.6700 --	0.6650 --

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We retain our bearish bias on NZD outlook, on both exogenous and endogenous factors. Selling pressure (in NZD) is expected to persist, following the AUD drag (due to RBA rate cut in May and decline in industrial metal prices). We also expect USD strength to remain in the driving seat in the lead-up to Jun FOMC meeting as markets re-adjusts Fed rate hike trajectory. Weak macro-fundamentals (as we have repeatedly mentioned) – subdued wage growth, benign inflation (although some signs of stabilization seen), challenging dairy market outlook – remain intact. Fonterra cut its 2016/17 forecast payout (26 May) for milk solids by 25cents/kg to $4.25/kg. This is below the breakeven point for most farmers. To add RBNZ Financial Stability Report (11 May) also highlighted concerns pertaining to the dairy and housing sectors. We think the case for a rate cut at the upcoming meeting (9 Jun) is strong and we are expecting at least 25bps cut to its OCR. Market implied probability of rate cut is only 33% while economists' consensus survey is for 25bps cut. This suggests markets have yet to fully price in a cut and that could mean further downside could be in play when markets start to price in.

- With bearish macro-economic factors in the backdrop, the change in USD dynamics (from a soft USD to firmer USD in the lead up to Jun FOMC) and renewed weakness in AUD, we revised our NZD forecast lower in 2Q to 0.6650.

- In the Financial Stability Report released 11 May, housing and dairy were cited as risks to financial stability. Dairy prices remain low with global dairy supply still expected to increase (due to growth in European supply); dairy farmers now face a 3rd season of negative cash flow with heavy demand for working capital and more so due to winter when cash flow is seasonally low. Weak milk prices and a relatively stable NZD have led to further downward revisions to the forecast payout for the 2015-16 season. RBNZ Governor Wheeler also noted that international credit spreads have widened, placing upward pressure on the cost of funds for NZ banks; the level of problem loans in the dairy sector is expected to increase significantly.

- Technically 0.6830 (50 DMA) could serve as immediate resistance before 0.6935 (50% fibo retracement of Apr 2015 high to 2015 low). Support at 0.6660 (200 DMA).

- **Growth and Inflation Outlook:** Domestic economy remains supported by net immigration, tourism amid accommodative monetary conditions, there are some signs that momentum could be decelerating. Recent data release was mixed - 1Q retail sales fell 0.8% q/q (vs. 1.2% prior) but PMI was firmer in Apr (56.5 vs. 54.7). 1Q GDP data only due for release on 16 Jun.

- 1Q headline CPI rose 0.2% q/q and 0.4% y/y basis. Non-tradable inflation rose 1% q/q while tradables fell 0.9% q/q. **NZ inflation remains well below its 1-3% target range and is now at 16-year lows, due to earlier NZ strength and the large decline in oil and commodity prices.**

- **Monetary Policy Forecast:** At the last RBNZ MPC meeting on 28 Apr, RBNZ kept OCR unchanged at at 2.25%, as expected. In the accompanying statement, RBNZ continues to express its **desire for lower NZD to boost tradables inflation** and assist the tradables sector; continues to highlight weakness in dairy sector, decline in inflation expectations and upward pressure on housing market due to high net immigration. RBNZ concluded by saying that **further policy easing may be required to ensure that future average inflation settles near the middle of target range**.

- **Latest Fiscal and External Balance Outlook:** 4Q current account deficit narrowed to -NZD2.61bn (from -NZD4.75bn in 3Q). 4Q 2015 current account deficit stood at 3.1% of GDP (narrowed slightly from -3.3%).

- In NZ budget announcement (26 May), the Treasury reported budget surplus of NZD668m (vs. NZD401m deficit). Budget surplus for the following 2 years have also been raised due to higher tax revenue and lower expenses. Treasury is forecasting GDP growth of 2.9% in 2016, 3.3% in 2017 and 3% in 2018. As a result of better than expected budget, the planned bond issuance for 2017-17 has been lowered to NZD7bn (from NZD9bn).

- **Key domestic events and issues to watch:** 1Q ToT (1 Jun); RBNZ meeting (9 Jun); 1Q GDP (16 Jun); May trade (27 Jun).

- **Technical Outlook:** NZD drifted lower for the month of May, taking cues from the decline in AUD. Last seen around 0.673.0 levels. **Bearish momentum on daily chart remains intact (although showing signs of waning) while stochastics is at oversold conditions.** 0.6830 (50 DMA) could serve as immediate resistance before 0.6935 (50% fibo retracement of Apr 2015 high to 2015 low). Support at 0.6660 (200 DMA).

JPY: Jawboning Remains The Weapon Of Choice For Now

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USDJPY	**110** --	**114** --	**116** --	**120** --

No Change from Previous Forecast

- **Motivation for the FX View:** The JPY slipped lower by 3.2% against the USD so far in May, reversing some of the 5.7% gains seen in Apr. Despite this respite in May, the USDJPY remains one of the best performing currencies so far this year, up 9.3%. The reversal in the JPY in May could be attributed to seasonal factors among others. The USDJPY tends to climb higher in the month of May. Also, the dollar resurgence amid increasing expectations of two rate hikes this year (one in Jun and the other in Dec) from one previously following hawkish FOMC minutes for Apr and various Fed speaks is also supportive. The USDJPY was also helped by jawboning from the BOJ and the government.
- In the absence of further concrete action by either the government/BOJ to shore up confidence in Abenomics, further jawboning remains the weapon of choice for now. We continue to expect the pair to end 2Q at 110 by end-2Q before rebounding towards the 116-levels by end-2016 and then to 120 by end-1Q 2017.
- Still further upside in the near term appears limited as investors continue to position themselves for further JPY strength in the absence of further BOJ easing measures. This is reflected in the long-JPY bets so far this year which should weigh on the USDJPY. There has however been some pull-back to around 59000 contracts in the week of 17 May after such bets peaked in mid-Apr at 71879 contracts. In addition, there was also a pull-back in portfolio inflows in the first two-weeks of May that could have provided support for the USDJPY. In May so far, foreign investors have sold off a net JPY0.36tn and JPY0.06tn in equities and government debt, helping to keep the USDJPY supported to date. Reinforcing the foreign portfolio outflow is the continued purchases of foreign equity and government debt by Japanese investors. In the first two weeks of May, Japanese investors have sold off a net JPY0.13tn of foreign equities and purchased a net JPY1.59tn of government debt. For now, outflows by both foreign and Japanese investors are likely to continue and keep the USDJPY elevated in the near term.
- The almost-foregone decision to delay the implementation of the consumption sales tax hike expected in Apr 2017 has provided the USDJPY with a lift in recent days. Speculation is increasing that

PM Abe will postpone the sales tax hike by two-and-half years till Oct 2019 to prevent the fragile economy from sliding into another recession. Even Finance Minister Aso – a fiscal hawk – is now singing the same tune in supporting a hike postponement. This delay will boost investor sentiments and encourage greater outflows while at the same time boost domestic equities. Together these are likely to be JPY-negative and lift the USDJPY higher.

- Our base case remains for the BOJ hold off adding to its ultra-loose monetary policy until 2H 2016. We expect a move at its 28-29 Jul meeting at the earliest. Aside from pausing to evaluate the impact of the negative interest rate policy (NIRP) – which remains misunderstood and unpopular among the public - on the economy, the BOJ is also mindful of the impact that any further easing could have on the Upper House elections due sometime in early Jul. To avoid any political implications, the BOJ could choose to hold off any further moves till after the election. Moreover, the BOJ would also want to avoid adding to the volatility that could arise from the outcome of the Brexit referendum in the UK on 23 Jun. Measures we expect the BOJ to possibly take includes extension of the base money, purchasing more ETFs and cutting interest rate further. Until then, we can expect further jawboning by the BOJ and government. This moves by the BOJ together with the expected hike by the US Fed in Jun and 4Q could lift the USDJPY higher towards the 116 by end-4Q 2016 and 120 by end-1Q 2017.
- The risk ahead is the rising concern of the efficacy of the policies of Abenomics, putting PM Abe's and BOJ governor Kuroda's credibility at risk should the economy fail to reflate. More importantly, the collapse in confidence could trigger a sell-off in the Nikkei and force large unwinds of long-JPY positions and risks the USDJPY falling back below the 100-levels.
- **Growth and Inflation Outlook:** The economy avoided a technical recession with the better-than-expected preliminary 1Q16 GDP print, which was up by 1.7% q/q sa annualized (SAAR) vs. market estimates of 0.3% and -1.1% in 4Q. Driving growth higher was an increase in consumer spending with household spending up 1.9% SAAR, and government spending up 2.8% SAAR. The outlook ahead though is not as sanguine. The earthquake that struck Kyushu island in Apr damaged infrastructure, housing and other capital stock in Kumamoto and Oita prefectures amounting to JPY2.4-4.6tn and is likely to be a drag on the economy in 2Q. The stimulus package for rebuilding these earthquake affected areas is likely to be felt only in 2H of the year. The external economy also remains weak, especially in light of the recent gains in the JPY that had seen profits of exporters drop. Exports contracted by 10.1% y/y in Apr (Mar: -6.8%), while imports slid a sharper 23.3% y/y (Mar: -14.9%). Thus, calls have increased for further stimulus to support the economy which seems unlikely at this point in time.
- Firmer global oil prices and a modest uptick in wages recently should provide consumer prices with a boost but this has not materialized. Headline inflation fell for the second straight month by 0.3% y/y in Apr (Mar: -0.1%), though this was slightly better than consensus' -0.4%. Core inflation (CPI less fresh food) fell 0.3% y/y (Mar: 0.3%). Still, the BOJ governor remains sanguine about achieving the 2% inflation target. He highlighted recently that the economy is no longer in a deflationary state even though deflation has not ended completely. The favoured

inflation gauge of the BOJ – the core core inflation which is headline inflation less fresh food and energy prices – remains above the 1.0% levels at 1.1% for the past three months as data for Apr is still not available. This should continue to provide comfort to the central bank that inflation is gaining traction. BOJ continues to expect core inflation to average 0.5% in FY 2016-17 and then to 1.7% in FY2017-18. Core inflation should rise to 1.9% in FY 2018-19.

- **Monetary Policy Forecast:** The next time the BOJ meets is on 15-16 Jun but no policy adjustment is expected. The central bank is likely to watch and wait for the Brexit referendum outcome on 23 Jun and for the expected Upper House elections in early Jul to be over before making its next move. Any further policy easing measures should be introduced at its 28-29 Jul policy meeting at the very earliest. Delaying further easing moves until Jul would also allow for US FOMC policy action to take place first. This of course does not preclude the BOJ from further measures if deems its 2% inflation under threat especially from FX risks as the BOJ governor has recently warned. Any further action by the BOJ cannot be piecemeal as seen when the NIRP was introduced. We expect the BOJ to introduce a comprehensive suite of measures including expanding the monetary base to JPY100tn from JPY80tn currently, increasing the purchase of ETFs to JPY10tn from JPY3tn and cutting interest rate further to -0.3%. Other possible measures that could be used include a tax on corporate profits to induce companies to spend rather than hoard cash and even possible negative lending rates. Helicopter money – i.e. the BOJ directly financing the government's budget deficit – is unlikely for now. But we believe this 'nuclear option' could be used as a last resort should other measures fail to reflate the economy.

- **Latest Fiscal and External Balance Outlook:** There are no plans for additional stimulus package to reinforce the record JPY96.7tn budget in place for this fiscal year. Instead, the spending from that budget will be front-loaded to spur the economy. There is an additional budget of JPY0.78tn approved by parliament on 17 May, but this is to help rebuild the communities devastated by the earthquake that hit both the Kumamoto and Oita Prefectures. With another stimulus package off the cards for now, focus will be on PM Abe's announcement on the consumption sales tax increase in Apr 2017 that is expected on 1 Jun. There is some speculation that PM Abe will delay the sales tax hike to allow the economy to recover from the impact of the previous sales tax hike.

- The current account surplus ballooned even more in Mar, bettering the surplus in Feb. The current account surplus rose to USD2.98tn in Mar after rising to JPY2.43tn in Feb – a level not seen since Mar 2007 (JPY3.36tn). There was a broad-base increase in almost all the components of the current account except for secondary income which saw a large decrease of JPY0.32tn. The goods and services surplus more than doubled that of Feb to JPY1.17tn (Feb: JPY0.58bn) and the primary income surplus rose to JPY2.13tn. This surplus together with the surplus in the financial account (largely the result of a smaller outflow in the other investment segment) helped to boost the overall balance of payments (BoP) surplus to JPY10.71tn in Mar from JPY6.33tn in Feb.

- **Key domestic events and issues to watch**: PM Abe will hold a press conference on 1 Jun to announce his decision on holding simultaneous elections for both houses of parliament and on the sales tax hike in Apr 2017. BOJ policy board member Sato speaks in Kushiro on 2 Jun and BOJ deputy governor Nakaso speaks in Akita on 9 Jun and then again to the National credit union association on 24 Jun. BOJ meets on 16 Jun to decide on policy. There is also the final print of 1Q 2016 GDP due on 8 Jun. JGB auctions in Jun: 10-year (2 Jun), 30-year (7 Jun), 5-year (9 Jun), 1-year (14 Jun) and 20-year (23 Jun).

- **Technical Outlook:** USDJPY broke out of the downward sloping trend channel (fromed since Jan 2016). Last seen at 111.20. While stochastics is near overbought conditions, weekly and daily momentum are bullish bias. Further upside towards 111.70 (38.2% fibo retracement of 2016 high to low), 112.40 (100 DMA), 113.60 (50% fibo) cannot be ruled out. Support at 109.40 (23.6% fibo).

CNY: Eye Fed Hike, Potential Inclusion Into Global Indices

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USD/CNY	**6.55** (6.50)	**6.50** (6.55)	**6.55** (6.50)	**6.57** (6.55)
USDCNH	**6.57** (6.50)	**6.50** (6.55)	**6.57** (6.50)	**6.60** (6.55)

No Change From Previous Forecast

- **Motivation for the FX View:** Dollar strength lifted USDCNH to levels around 6.59 and we continue to see a little bit more upside for the USDCNH. We had anticipated the dollar strength for May and that was also a key reason why we had flagged in our last FX Monthly that **"the depreciation in the yuan against the basket may take a pause in May".** Whilst the yuan is still under bearish pressure, limited dollar strength in the next 3-6 months could mean that USDCNH is also likely to trade largely sideways for the rest of the year. That said, we stick to our view for further yuan weakness against the EUR, GBP, JPY, CAD and MYR. With FX Reserves still recorded at USD3.2trn, markets are more or less convinced of PBOC's ability to keep CNY stable against the USD. This will naturally keep the gap between onshore and offshore yuan from widening drastically this year. However, **we had adjusted our USDCNY and USDCNH forecasts to reflect the timings of the Fed hikes, impact on the dollar, concomitant impacts on the USDCNY and USDCNH. Our latest forecasts also take into consideration the tendency for the premium of USDCNH to USDCNY to rise as dollar strengthen.**

- In addition, there are a few events that could lend support to the RMB and financial markets; The potential inclusion of China's equities or debt in global indices such as MSCI (15 Jun) and JPM emerging bond index could translate into potential inflows into the onshore markets as asset managers that track these indices are forced to gain exposure to Chinese equities/bonds. The result is a buffer for CNY against capital outflows.

- A somewhat stable yuan does not mean that the economy has seen fundamental improvements. **China still has excess capacity,**

heavily indebted corporations and huge liquidity injections continue to add pressure on the yuan in the medium term. However, the State Council has shown a certain level of commitment to eradicating excess capacity including a plan for 1.8mn job losses in the coal and steel sector. The Chairman of the State Owned Asset Supervision and Administration Commission assured that big SOEs will strengthen as a result of the plan to cut overcapacity and duplication will be eliminated. In addition, the government is also focusing on emerging and higher-value industries including aerospace, nuclear power, high speed rail, renewable energy, smart grid technology. We are hopeful that liquidity could be channeled into building new growth engines. However, economic rebalancing efforts are likely to take time.

- In the near-term, industrial profits saw modest growth of 4.2%y/y in Apr. We also see that 60% of industrial profits are now made up of non-overcapacity sectors. Growth trajectory is still L-shaped, as widely acknowledged by top officials. We do not see a strong rebound in economic indicators in the near-term.

- **Our monthly Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) showed the score for China improved to 4.7 (with 1 being the best and 9 being the worst) due to a strong performance of its fiscal score that more than offsets its slight deterioration in its inflation score.
- **Growth and inflation outlook:** 2016 is set to be a year focused on achieving growth stability, yuan stability and deleveraging with stability. As our macro strategist *Willie Chan* had pointed out, the debt to equity swap is a key source of uncertainty. The scheme was first announced in Mar as a way to restructure corporate debt. The finer details are still being discussed and perhaps the most important question is what kind of debt the banks should take on – performing or non-performing? Non-performing loans has risen to 2008 levels (last seen at CNY1.27trn). To be sure, debt to equity swap can still happen under the current banking regulation. Debts can be swapped for shares if the latter were used as collateral for loans with the condition that the banks sell the shares within two years. While ordering banks to swap NPLs for equities could free up the capital for banks to engage in more productive lending, there is wide concerns that the practice could increase moral hazard. Firms may engage in aggressive borrowing knowing that the banks would be able take the bad loans from them if they are not able to pay up. The most adverse impact is on banks which will no longer have the first claim to risk in times of bankruptcy.

- Mar PMI-mfg came in at 50.1 vs previous 50.2. Non-mfg also came in at 53.5 from previous 53.8. The Caixin version was also lower at 49.4 vs. previous 49.7. Growth of exports slowed to 4.1%y/y, close to consensus. Imports fell -5.7%y/y, a steeper decline compared to Mar's -1.7%. Trade balance widened to CNY298bn from previous CNY194.6bn.

- Inflation steadied (again) at 2.3%y/y for Apr. PPI showed less contraction by -3.4%y/y from previous -4.3%. **With PBOC resuming liquidity injections in Apr via MLF and SLF, we continue to expect liquidity support for the old and new economies in China.** Home mortgage loans continued to rise in

1Q on the back of easy monetary conditions. Macro prudential measures should remain in place in the tier-one cities. The growth in the real estate sector should continue to have positive spillover effects in mining, construction, consumer goods and real estate services.

- **Monetary Policy:** The liquidity management is mixed for May with an approximate CNY570bn drained via OMO. The central bank continued its lending via its medium term lending facility in three instances and over shorter tenures such as 3M and 6M. In total, PBOC has injected CNY1.205trn, an assuring start for 2Q. Even so, it is still well within the amount of liquidity injected in Jan via OMO and MLF, recorded at CNY2.0375 trn.

- **Liquidity management is still key and with a significant number of default cases**, the 5yr CDS is elevated at around 123, compared to historical average of around 100. 7-day repo rate remained at around 2.5% while 3M-SHIBOR has surged 2.94% from a low of 2.79% in Mar. While the use of targeted liquidity measures such as pledged supplementary lending (PSL) and medium term lending facility are likely to continue, **we do not rule out further broad based easing and continue to look for 150bps cut - 50bps in each quarter - the next one could happen as soon as Jun.**

- Supply side reforms imply changes to its monetary policy as well. PBOC is in the midst of establishing an interest rate corridor and has looked into using the SLF rates as the ceiling of the interest rate corridor. The overnight lending rate has so far been steadied at 2.75% whilst that of the 7-day is at 3.25%. Moving forward, the central bank has to ensure the transmission mechanism of future rate cuts to be filtered down to the SMEs before there can be significant breakthroughs in its exchange rate policy.

- **Latest Fiscal and External Balance Outlook:** The budget deficit widened to 2.4% of GDP in 2015 from previous 2.1% in 2014. Supply side reforms also apply to its fiscal plan for 2016. In fact, Vice FinMin Zhu Guangyao had said the threshold of 3% implies that there is still room for expansionary fiscal policy. This could serve to boost disposable income and domestic consumption.

- The 1Q current account surplus halved to US$48.1bn from the previous US$84.3bn in 4Q15. The outflows via its financial accounts was lower at U$48bn vs the previous U$50.6bn. The latest release of BOP for 4Q 2015 suggests that the capital outflow via trade, deposit and currency, loans have peaked in 3Q last year. The option market suggests that a strong majority of investors still expect CNY to weaken and that should also mean outflow pressure will persist but existing capital account management as well as RMB management suggest that yuan capital outflow could remain at an orderly pace.

- **Key domestic events and issues to watch:** May PMI-mfg is due on 1 Jun along with Caixin version. The China-US Economic and Strategic dialogue is scheduled on 6-7th. Foreign reserves and trade data are curiously scheduled for release on 7th and 8th respectively. CPI and PPI on the 9th. Activity data will be released on the 12th. Liquidity numbers are due from 10th-15th. We also like to watch Apr industrial profits due on the 27th. We also eye potential inclusion into MSCI and JPM bond indexes.

- **Technical Outlook:** USDCNH was last seen around 6.5890, within the 6.55-6.60 range. Bullish momentum on the wane and stochastics shows signs of turning lower from overbought levels. Still correction could be shallow as this pair seems more determined to keep an upside bias. Eye the break of the 6.5912 (38.2% Fibonacci retracement of the Oct-Jan rally) towards then next big 6.6350. A failure to break there could mean a potential mini double top there. Support is at 6.5590 (100-DMA). Resistance is at 6.5820 (19 May high).

KRW: Potentially a Choppy Month Ahead

Forecast	2Q 2016	3Q 2016	4Q2016	1Q 2017
USD/KRW	1177 (1160)	1167 (1190)	1200 (1170)	1180 --

No Change from Previous Forecast

- **Motivation for the FX View**: We expect **choppy price action in the month of Jun as many market events await**, including the lead-up to **FOMC meeting (16 Jun) where focus is on the decision and statement**. USD could be broadly supported leading into D-day but we do not rule out "buy the rumor (USD), sell the fact (USD)". We do not expect a big sell-off in risk assets on rate hike (our house view) as Fed is expected to reiterate a gradual pace of tightening. We see the rate hike as a testament to US economy's progress towards recovery. **Another key focus is on MSCI decision to potentially include Korea in its developed market index (14 Jun).** The inclusion will be perceived as positive; portfolio inflows may accelerate and lend strength to the KRW. Given the mix of events in Jun, we expect USDKRW to trade 1160 – 1215 range.
- We calibrate our USDKRW forecasts - adjusting it higher for 2Q in light of the recent market moves, lowering it in 3Q as we expect a period of USD softness and increasing it for end-year for to take into account the 2nd Fed hike.
- Other focuses will be on **further details regarding Korean-style QE (corporate restructuring/ recapitalision of Korea Development Bank), supplementary budget (dates unknown but likely to be announced in Jun-Jul) as well as BoK meeting (9 Jun).** On the latter **we do not expect the BoK to cut policy rate at the upcoming meeting**. We reiterate that the BoK is skeptical how effective it would be for them to act alone as Governor Lee previously mentioned that a cut would be more effective if supported by fiscal stimulus and structural reform. On the former it is unlikely to have direct impact on the KRW but it is **likely the BoK could act to cut policy rate as soon as there is some agreement or progress to implement corporate restructuring and/or supplementary budget.**
- Risk to our USDKRW 1-month view include deferred decision by Fed to raise rate in Jun (could see further USD downside), a much hawkish FOMC statement triggering massive risk asset sell-off and/or deterioration in risk sentiment (could result in further USD upside).

- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for S.Korea worsened to 6.4 (from 6.3 in Apr). The deterioration was due to GDP and yield while fiscal saw marginal improvement.

- **Growth and Inflation Outlook:** 1Q prelim GDP expanded +0.4% q/q; +2.7% y/y, in line with estimates. Final print is due to be released on 2 Jun. While manufacturing PMI inched into expansionary territory for the first time this year in Apr (50 vs. 49.5 in Mar), IP fell in Mar (-2.2% m/m vs. +3.3% in Feb) and exports fell by more in Apr (-11.2% y/y vs. -8.2% in Mar).

- BoK lowered 2016 GDP growth to 2.8% (from 3%) and inflation forecast to 1.2% (from 1.4%), due to weaker than expected domestic economic growth in 1Q 2016 and downward revision to global economic growth. We retain our bearish bias on the economy against a backdrop of ongoing sluggish external demand (16 consecutive months of decline), rising risks of slowing recovery in domestic demand, benign inflation outlook and ongoing geopolitical tension.

- **Apr headline inflation was flat on y/y terms (+1%).** On sequential basis, headline inflation rose slightly (+0.1% vs. -0.3% prior) as rise in fishery, meat, petroleum prices more than offset the decline in agricultural prices. Core inflation marginally rose to 1.8% y/y (from 1.7% y/y in prior month).

- **Monetary Policy Forecast: We expect BoK to keep policy rate on hold at 1.5% at the upcoming meeting (9 Jun).** We reiterate that the BoK is skeptical how effective it would be for BoK to act alone as Governor Lee previously mentioned that a cut would be more effective if supported by fiscal stimulus and structural reform. It is **likely the BoK could act to cut policy rate as soon as there is some agreement or progress to implement corporate restructuring and/or supplementary budget**.

- At the last MPC meeting (13 May), BoK kept policy rate on hold at historical low of 1.5% for the 11th straight meeting as expected. The 4 new MPC members who voted for the first time did not cast any dissent vote. MPC maintained its dovish tone – noted continued decline in exports and slowdown in job growth while acknowledged moderate improvement if domestic demand and economic sentiment. The accompanying statement talked about corporate restructuring but gives no further details apart from watching progress and impact on overcapacity sectors.

- Earlier in our previous monthly outlook, we mentioned “Korean-style” quantitative easing involving the purchase of Korea Development Bank bonds to finance corporate restructuring as well as direct purchase of mortgage-backed securities to convert household mortgages into longer term amortizing mortgages. This is a **targeted form of quantitative easing to help with financing corporate restructuring as well as aimed at lowering the burden of servicing mortgages for households** (in an attempt to ensure debt sustainability and reduce risk of households NPLs). These plans are yet to be approved. The government is also looking to explore fiscal impulse to do its fair share of heavy lifting to improve growth potential and re-design of tax structure to encourage corporate investment, R&D, etc.

- **Latest Fiscal and External Balance Outlook:** Current account surplus narrowed to $10.1bn in Mar from revised $10.95bn in Feb due to narrowing deficit in the services sector and faster decline in imports than exports. While current account surplus may be the lowest level in 3 months, Korea has posted its longest monthly current account surplus for 49 months.

- According to the Public Finance 2015 report issued by National Assembly Budget Office, fiscal deficit for 2016 is expected to widened to -2.3% of GDP. Sovereign debt to GDP is expected to climb to 40% of GDP for 2016.
- **Key domestic events and issues to watch:** S. Korea releases May exports and CPI inflation (1 Jun); 1Q final GDP (2 Jun); BoK meets (9 Jun); MSIC announcement of decision on potential Korea inclusion to Developed markets index (14 Jun); May IP (30 Jun).
- **Technical Outlook:** USDKRW drifted higher in the month of May. High was seen at 1199 (31 May). Technical signals are mixed - Bullish momentum on daily chart is waning and stochastics shows signs of falling from overbought conditions. But 21 DMA is about to cut 200 DMA (bullish signals). Weekly momentum and stochastics are also indicating bullish signals. Resistance at 1200 (61.8% fibo retracement of 2016 high to low) before 1217 (76.4% fibo). Support at 1186 (50% fibo, 100 DMA) before 1172 (21, 200 DMAs and 38.2% fibo) before 1160 (50 DMA).

SGD: Tracking The Dollar Moves

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USD/SGD	**1.3800** (1.3550)	**1.3850** (1.3750)	**1.3900** (1.3850)	**1.3950** (1.3900)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USDSGD has been on the upmove since the beginning of May, lifted first by cautious risk sentiments regarding global growth and then on increasing expectations of a Fed fund rate hike in Jun that led to a resurgence in the dollar. Moreover, the surprise shift in policy to neutral by MAS at its Apr meeting continues to weigh on the SGD. These have resulted in the USDSGD climbing higher faster than had expected. In fact, the recent moves have come in at least a quarter earlier than expected.
- The sell-off in Singaporean assets continued in May on the back of further SGD weakness and as market participants continues to add to their long USDSGD in the aftermath of MAS policy shift. Like in Apr, foreign investors likely persisted in their sell-off of government debt in particular as reflected in the rising bond yields across most government debt except for the 1Y and 30Y. Bond yields were higher by 3.95-18.44b in the month to May. There remains speculation of a further move by the MAS at its Oct meeting as a result of the lower hurdle that the MAS has now set to trigger a policy shift. Our base case though remains for the MAS to remain hold for now, barring a downward revision to growth and inflation expectations for the rest of the year and into 2017.
- It also does not help that the economy continues to face domestic and external headwinds that is likely to challenge the

USDSGD. Domestically, the economy is underperforming due to the ongoing economic restructuring to reduce the reliance of foreign workers and towards more productivity-driven growth. External headwinds, including the sluggish global growth outlook amid a restructuring China and the ongoing normalization of rate hikes by the US Fed, could soften risk appetite and lead to greater volatility in the FX markets and weigh on the SGD. Even the strong persistent balance of payments surpluses are unlikely to keep the USDSGD from heading towards the 1.40-levels by end-2016 from its current levels around 1.38.

- Given our base case of two hikes by the Fed this year – one in Jun and the other by Dec – which should keep the pair buoyed as the SGD continues to take its cues from dollar moves ahead. Moreover, upmoves in the USDJPY back above the 110-handle and beyond should lift the USDSGD along with it (given the positive correlation with the USDSGD). As well, a relatively stronger MYR as a result of firmer global oil prices could push the SGDMYR lower and put downward pressure on the SGD. As a result of these recent market developments, we slightly revise the USDSGD to come in at 1.3800 by end-2Q 2016 before climbing higher to 1.3850 by end-3Q and then to end the year at 1.3900. The pair upmove should likely continue into 2017 with the pair ending 1Q 2017 at 1.3950.

- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Singapore rose to 4.1 from 3.8. Driving the score higher was the increase in current account, fiscal and reserves risks. This should weigh on the intrinsic value of the SGD. Our model shows that the SGD NEER was last seen 0.05% below the mid-point implied at 1.3800. Upperbound is implied at 1.3524 while lowerbound is now at 1.4047.

- **Growth and Inflation Outlook:** Final 1Q GDP print released did not have a significant impact on the pair. The economy grew by 1.8% y/y (0.2% saar q/q) in the final print for 1Q 2016, coming in below market estimates of 1.9% y/y (0.6% saar q/q). However, this was better than the advanced estimates of 0% saar q/q, helped by a resurgence in manufacturing which was up by 23.3% saar q/q. The government maintained its full-year growth forecast at 1-3% for 2016 barring "the full materialization of downside risks". Apr industrial production seems to indicate that growth remains on track, printing growth of 2.9% y/y vs. Mar's 0.1%. Manufacturing growth in Apr was led by gains in biomedical and electronics, both of which were up by 14.9% and 10.9% y/y respectively. The outlook for manufacturing appears to be improving with results of the recent business expectation survey hinting of a moderate recovery following last quarter's dip of 1.0% y/y. NODX though remains weak with overall shipments falling by 7.9% y/y in Apr, dragged lower by weak shipments of both electronics and non-electronics (Apr: -8.1% and -7.4% y/y respectively). With external demand unlikely to provide much support to growth in 2016 given the fragile global economy, our economic team maintains its 2016 growth forecast at 1.7% for 2016 before rebounding slightly to 2.0% in 2017.

- Headline inflation continued to decline in Apr, falling by 0.5% y/y (Mar: -1.0%) while core edged higher by 0.8% (Mar: 0.6%). Contributing to the improvement in headline inflation was higher food prices and an improvement in housing cost. Mitigating these improvements was the continued drop in transport cost, which fell by a larger 5.4% y/y in Apr than Mar's -4.3%. Higher core inflation (CPI ex-accommodation and private transport) was due to higher services inflation (up 0.7% y/y in Apr vs. 0.4% in Mar) and a smaller drop in electricity tariffs. The outlook for inflation has not changed and is still benign. Imported inflation remains muted given ample supply buffers and weak global demand. Moreover, even though oil prices have edged back towards USD50/barrel, its average prices are expected to still be lower for 2016 compared to last year. Domestically, labour market tightness is expected to come off slightly with wages growth projected to slow. The pass-through from wage costs to consumer prices should continue to be constrained by the subdued economic growth environment. The recent easing of rules for motor vehicle loans by the MAS could provide inflation with a lift that could help headline inflation come in closer to the upper band of its current projection of -1.0-0.0% for 2016. Core inflation is still expected to come in at the lower half of its 0.5-1.5% forecast range, barring a sharp rise in global oil prices.

- **Monetary Policy Forecast:** After surprising the market with a shift to a neutral policy stance at its Apr meeting, we do not expect the MAS to adjust its policy again at its Oct meeting. MAS had progressively removed the crawl because the economy did not need it for balance and the medium term path is closer to a constant now than upward sloping given current domestic and external conditions. Unlike past occasion when the slope was flattened swiftly, the recent change in the slope was in response to the slow drfit to inflation. In the short term, in absence of significant shocks, an adjustment to the NEER band would be unnecessary.
- There have so far been no changes to the MAS' expectations for growth and core inflation as discussed above and the likelihood that the MAS would contribute to financial market volatility by creating any policy-driven volatility. This is barring disappointing data that could threaten the MAS' assumption for growth and core inflation that could increase the risk of another move in Oct. In the unlikely event that these risks materialize, we could expect the next move by the MAS to be a downward re-centering of the SGD NEER. Thus, while the hurdle for further policy adjustments have been lowered with the policy adjustment in Apr, we expect the MAS to stand pat unless risks to its assumptions for growth and core inflation materialize.

- Since our last report, the USDSGD has bounced higher but have not taken domestic interest rates higher by the same proportion. Instead, the grind higher is more gradual. To date, the 3-month SIBOR (3MSIBOR) has come off from its five-year high of 1.254% (19-27 Jan) to hover around the 1.0% levels at the point of writing. The more gradual pace of rate increase should also moderate the rise in mortgage rates for now. Deposit rates (for 12-month fixed) have not risen since end-Jan and remains at around 0.35% currently. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, seems limited for now. We continue to expect the 3MSIBOR and 3MSOR to end 2016 and 2017 at 1.59% and 1.70% and 2.29% and 2.39%respectively.

- **Latest Fiscal and External Balance Outlook:** The current account surplus narrowed to SGD17.77bn in 1Q 2016 from SGD20.71bn in 4Q 2015. The narrowing current account surplus could be primarily attributed to the smaller surplus in the goods and services account, which came in at USD26.19bn in 1Q 2016 vs.

4Q's SGD29.20bn in 4Q even as the deficit in the primary balance account narrowed to SGD4.43bn (from -SGD5.26bn in 4Q). The financial account surplus widened to USD25.88bn due to a larger 'others' segment (1Q: SGD38.53bn) that offset the outflow of portfolio investment (1Q: -SGD14.95bn) and more moderate direct investment outflows (1Q: -SGD4.61bn). The overall balance of payments deficit widened to SGD8.88bn in 1Q 2016 from 4Q's deficit of SGD0.35bn.

- **Key domestic events and issues to watch:** No significant event or issue on tap.
- **Technical Outlook:** The rise in USDSGD met with 100 DMA resistance at 1.3830 levels. Pair was last seen at 1.3810 levels. Bullish momentum on daily chart is waning while stochastics is at overbought conditions. Support at 1.3720 (21 DMA) before 1.3610 (23.6% fibo retracement of 2016 high to low). Resistance at 1.3960 (200 DMA).

MYR: Interim Weakness Before Resumption of Strength

Forecast	2Q 2016	3Q 2016	4Q2016	1Q2017
USD/MYR	**4.0500** (3.9000)	**3.9500** (3.9500)	**4.0000** (3.8500)	**4.0000** (3.9000)

Previous forecast in parenthesis.

- **Motivation for the FX View:** We see interim weakness in the MYR leading up to FOMC meeting on 16 Jun, as USD strength is likely to remain supported. But MYR weakness is likely to be short-lived as we still see a resumption of strength in the medium term. The drivers underpinning our conviction are both domestic and external driven.
- External drivers include a 1) rebalancing of global oil supply and demand underway, which saw the decline in oil price volatility to levels not seen since Jul 2015 and rise in oil prices towards $50/bbl handle. (YTD oil prices and MYR correlation coefficient remains significant at 0.75). 2) In search of attractive yields - MYR bond yields remain attractive (last MGS 10.5y issue saw a decent bid/cover of 2.193x with average yield of 3.90% despite recent Ringgit weakness -4.3% MTD) amid accommodative monetary conditions globally and still-supported risk sentiment. 3) FOMC rate hike (our house view is in Jun) may not necessarily imply a big sell-off in risk assets as seen in the lead-up to FOMC meeting in 2015 as we still see Fed reiterating a gradual pace of tightening in 2016. We see the rate hike as a testament to US economy progressing towards recovery (especially when US labor market is near full employment and PCE core inflation has slowly edged above 2%). Taken together, this may not necessarily bode ill for risk assets and may continue to keep sentiment supported.
- Domestic drivers include accommodative monetary conditions at home, re-calibrated budget (perceived as positive), resilient domestic demand as well as improving FX reserves to import and short-term debt. While domestic concerns remain, they are

gradually subsiding and this is helping to restore market confidence and improve investor risk appetite.

- In light of the recent market moves, we recalibrate our USDMYR forecasts. At the same time we caution for short-term weakness especially in the lead-up to FOMC meeting (16 Jun). Topside should see 4.15/20 levels.
- **Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.54 levels.** We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We still expect to see some stability returning to Ringgit as political/contingent liability risk subsides, fiscal consolidation/reforms gains traction, oil prices stabilize and uncertainty regarding Fed rate hike subsides.
- External reserves as at 13 May 2016 rose to USD97.2b (MYR382.3b) from USD97.0b (MYR381.4b) on 30 Apr2016. This is equivalent to 7.9 months of retained imports and 1.2times of short-term external debt. Latest figure remains up trend amid mix trends in capital flows. Year-to-date, external reserves increased by +2.0% from USD95.3b at end-2015.
- Foreigners were net sellers of Malaysian equities thus far in May 2016 i.e. -MYR2.56b compared with the net buys of +MYR0.5b in Apr 2016 and +MYR6.1b in Mar 2016. This coincided with recent weakness in MYR against USD as it depreciated to 4.12 (24 May) compared with 3.9050 at end-Apr 2016.
- Despite the net foreign selling of Malaysian equities and the decline in MYR vs USD, the climb in external reserves in 1H of May 2016 suggests foreigners remained net buyers of Malaysian debt securities so far this month, sustaining the momentum in the past two months (Apr 2016: +MYR6.2b; Mar 2016: +MYR11.5b), and underscoring the relatively more “sticky” type of investors in the local bond market compared with those in the equity market, with central banks, governments, pension funds and insurance companies accounting for 42% of foreign holdings of Malaysian Government bonds.
- **Our monthly Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Malaysia worsened to 5.3 in Apr, from 4.8 in Mar. Deterioration came via politics, current account, inflation and fiscal.
- **Growth and Inflation Outlook: 1Q 2016 real GDP growth slowed for the fourth consecutive quarter** to +4.2% YoY (4Q 2015: +4.5% YoY). **Domestic demand slowed** (1Q 2016: +3.6% YoY; 4Q 2015: +4.0% YoY) due to the virtually stagnant investment (1Q 2016: +0.1% YoY;4Q 2015: +4.0% YoY) from both private and public sectors. **Net external demand declined**(1Q 2016: -12.4% YoY; 4Q 2015: +4.3% YoY) as exports of goods & services declined (1Q 2016: -0.5% YoY; 4Q 2015: +4.0% YoY) while imports of goods & services grew, albeit at slower pace. **The only bright sparks were in private and government consumption.**
- **Our Economists maintain 2016 real GDP growth forecast of +4.3% (vs. Official 2016 growth forecast stay at 4.0%-4.5%).** The **case for a bottoming in the quarterly growth slowdown is suggested by the back-to-back pick up in consumer spending, implying GST effect may be over.** We also expect **public investment to recover** from the 1Q 2016 drop, taking cue from

the recent awards of contracts under major public sector infrastructure and investment projects like KVMRT2, PBH and RAPID. There is also the **potential upside to Government spending in view of the rebound in crude oil price** to around USD47/bbl currently (2016 YTD: USD37/bbl) vs Budget 2016's assumption of USD30-35/bbl average for the year.

- However, the **prospect for private investment is challenging amid general economic uncertainty and pressures on corporate profitability** that make companies cut, withhold or slow their capex. The "wild card" is net external demand, which as volatile as the global environment, commodity prices and currency.
- **Our Economists lowered 2016 inflation forecast range by -0.3 ppt to 2.7%-3.2% (2015: 2.1%) from 3.0%-3.5% previously.** Besides the GST base effect, the cha**nge reflect subdued global inflation** given the persistent deflationary environment. Domestically, the slow**ing GDP growth results in our Economists' estimate of negative output gap last quarter, which would cap demand-pull inflation.**
- But expect volatile trend in monthly inflation rate, hence the full-year forecast range due to factors such as the volatile currency and commodity prices –namely crude oil prices; weather and seasonal effects on food prices; scheduled reviews and the still-pending decisions on "administered prices" like the gas and electricity prices as well as PLUS highway toll rates; the cost impact of specific domestic policies, such as the hike in levy on foreign workers effective 18 Mar 2016 (Peninsula Malaysia for now) and the Minimum Wage increase on 1 July 2016.
- Our Economists are also mindful of the Price Control & Anti-Profiteering Act's restriction on traders' price increases between 2 Jan 2015 and 30 June 2016 to prevent "profiteering" and excessive price increases following GST implementation. There is the risk of price hikes after the expiry of this restriction period in view of the higher operating costs due to the various non-GST factors like the continued subsidy rationalisation / removals, reviews administered prices, and the above-mentioned labour costs.
- April headline and core inflation rate moderated to +2.1% YoY (Mar 2016: +2.6% YoY) and +2.3% YoY (Mar2016: +3.6% YoY) respectively. YTD 2016 headline inflation is +3.2% YoY while core inflation is at +3.3% YoY. The **moderation in both CPI and core CPI reflect base-effect from GST introduction back in Apr 2015 amid the broad-based easing in all CPI components in Apr 2016.**
- **Monetary Policy Forecast:** The Monetary Policy Committee (MPC) meeting on 18-19 May 2016 was the first chaired by the **new Governor Datuk Muhammad Ibrahim,** who replaced Tan Sri Dr Zeti Akhtar Aziz effective May 2016 for a five-year term. The MPC decided to release **future Monetary Policy Statement (MPS) on the second day of the MPC meeting earlier at 3pm instead of 6pm**.
- **BNM kept the Overnight Policy Rate (OPR) and the Statutory Reserve Requirement (SRR) ratio unchanged at 3.25% and 3.50% respectively on 19 May.** BNM described the current levels of OPR at 3.25% as accommodative and supportive of economic activity,
- Our Economists are **not ruling out the possibility of a 25bps cut to OPR (now at 3.25%) in 3Q 2016**, depending on whether

economic data between now and up to the release of 2Q 2016 real GDP in mid-Aug 2016 show quarterly growth has bottomed or not.

- There was also no change in SRR, currently at 3.50%, indicating that **BNM is comfortable with current domestic liquidity.** This is despite data showing money supply growth decelerated for the sixth consecutive month in Mar 2016 to +0.9% YoY, dragged by the banking system's total deposits which shrank -0.9% YoY in Mar 2016 (Feb 2016: +1.2%) and amid slowing total loans growth (Mar 2016: +6.4% YoY; Feb 2016: +7.4% YoY) on moderation in both business loans (Mar 2016: +6.5% YoY; Feb 2016: +8.0% YoY) and household loans (Mar 2016: +6.4% YoY; Feb 2016: +7.0% YoY). Nevertheless, the 3-month KLIBOR progressively eased from the high of 3.84% p.a. at end-Dec 2016 to 3.79% p.a. at end-Jan 2016, 3.74% p.a. at end-Feb 2016, 3.71% p.a. at end March 2016, 3.69% p.a. at end-Apr 2016 and 3.67% p.a. currently – the lowest since Aug 2014.
- **Latest Fiscal and External Balance Outlook:** According to the latest revised budget (released 28 Jan), the government aims to maintain its 2016 fiscal deficit at 3.1% of GDP via a series of restructuring steps (operating and development expenditures cuts) that are expected to save the government MYR9bn. Malaysia's fiscal and broader economic outlook could still be under pressure from weaker commodity prices in 2016. **The revised Budget has adjusted lower its oil price assumption to US$30-35/bbl (from $48/bbl).** Downside pressure on rating agencies' 'Stable' outlook could arise in 2H 2016 if oil price averages below US$30/bbl as that may trigger projection of fiscal revenue shortfall.
- Exports growth in Mar 2016 moderated to +0.2% YoY (Feb 2016: +6.7% YoY) but imports slumped by-5.5% YoY (Feb 2016: +1.6% YoY), resulting in a wider trade surplus of +MYR11.2b (Feb 2016: +MYR7.4b). Commodity exports fell further in Mar 2016 as it contracted by –21.6% YoY (Feb 2016: -17.6% YoY) while shipments of major manufactured products moderated to +4.1% YoY (Feb 2016: +13.7% YoY).Volatility in commodity prices continues to weigh on commodity exports, especially the oil & gas related shipments, while manufacturing exports appear to be impacted somewhat by MYR appreciation amid the sluggish global manufacturing activities. We are also keeping an eye on the impact of recent change in domestic labour policy amid complaints by businesses –including manufacturing exporters –on the adverse cost and operating effects of the hike in foreign workers' levies, freeze on intake of new foreign workers, as well as the upcoming Minimum Wage hike on 1 July.
- Current account surplus was sustained but narrowed in 1Q 2016 on smaller goods account surplus and wider services account deficit although income account deficit narrowed. Financial account surplus was also sustained on net inflows of both portfolio and direct investments.
- **Key domestic events and issues to watch:** Key domestic events and issues to watch: Trade data (3 Jun); FX reserves (7 and 21 Jun); CPI Inflation (15 Jun).
- **Technical Outlook:** USDMYR drifted higher over the past few weeks. Momentum remains bullish bias. Resistance remains at 4.14 (50% fibo retracement of 2016 high to low). 21 DMA looks on track to cut 100 DMA to the upside in coming days and could suggest upside pressure. We caution that a break above 4.14 on

daily close could trigger stop-buy orders and expose the pair to 4.1880 (200 DMA). At the same time stochastics is suggesting the pair nearing overbought conditions. Support at 4.08 (100 DMA), 4.0720 (38.2% fibo).

IDR: Near Term Headwinds

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USDIDR	13600 (13200)	13300 (12950)	13150 (12500)	12950 (12400)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** In a reversal from Apr, the IDR has fallen by about 2.8% against the USD so far in May on the back of the unwinding of carry trades amid weak risk appetite. This was partially triggered by the market playing catching up to the fact that the US Fed could actually hike the fund rate by more than once this year. Markets are now aligning their expectations with our house view for two hikes in 2016 – one in Jun and the other in Dec. As well, the possibility of another rate cut in Jun as well as the growth downgrade by BI for 2016 weighed on the IDR. With near term risks now tilted to the upside in 2016, the USDIDR could remain elevated for a while longer before heading back lower.
- Much of the upmoves in the USDIDR recently could be attributed the unwinding of carry trades as risk appetite wane with the rise in expectations of a Fed fund rate hike in Jun. Also concerns that BI could cut its policy rate further in Jun before a Fed fund rate move also weigh on the IDR. Our base case though remains for the BI to remain on hold for the rest of the year while it transitions to a new monetary policy rate – the 7-day reverse repo rate in Aug. The slight downward revision to 2016 growth outlook by BI is also not helping. All of these has put downside pressure on the yield differentials with the UST and resulted in an outflow from government debt in May to date.
- Foreign investors have removed a net +IDR9.8tn from their outstanding holding of government debt on 1-26 May (latest data available) compared to the addition of a net IDR20tn in Mar and Apr. Year-to-date though, foreign investors have added a net IDR57.84tn to their outstanding holdings of government debt vs. IDR97.17tn for the whole of 2015. Similarly, the soft risk appetite has resulted in foreign funds selling a net USD87.24mn in equities so far in May vs. the gains of USD22.18mn in Apr. For the year so far, foreign investors have purchased a net +USD250.34mn in equities compared to the +USD1.58bn that was sold off for the whole of last year. Thus, should the sell-off of IDR assets continue, we could see near term downside pressure on the IDR, keeping the USDIDR elevated as a result.
- We believe that medium- to long-term fundamental outlook for the USDIDR remains intact. The improvement in economic fundamentals (including narrower current account deficits), government initiatives to liberalize and reforms to the domestic economy have been key to risk-supported sentiments and the IDR

so far. The 12 stimulus packages introduced by the government have not only encouraged greater foreign portfolio investment but FDI as well as reflected in the 4.5% and 17.6% y/y increase respectively in FDI in 1Q in dollar and rupiah terms. Moreover, the recent decision by the Golkar Party, the second largest party in parliament, to join President Jokowi's ruling coalition has strengthened the president's hands in reforming the economy and pushing through necessary legislations. All of these are IDR-positive.

- Given the recent market development, we now expect the USDIDR to remain elevated above the 13000 levels for the rest of the year. We expect the pair to trade higher to 13600 by end-2Q before easing off to around 13300 by end-3Q and 13150 by end-2016. The downside pressure should continue into 2017 and allow the pair to end 1Q 2017 at 12950.
- **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Indonesia worsened to 5.4 from 5.2. This was due to the deterioration in fiscal risk. This should weigh on the intrinsic value of the IDR.
- **Growth and Inflation Outlook:** GDP growth disappointed in 1Q 2016, expanding by 4.92% y/y compared to 5.04% in 4Q 2015. The slower than expected growth could be attributed to the underperformance of government expenditure, which rose by just 2.93% y/y in 1Q vs. over 7% in the last two quarters. As well, investment spending moderated to 5.57% y/y in 1Q from 6.9% in 4Q. The external economy remains a drag on the economy with exports down 3.64% y/y and imports by 4.24% y/y in 1Q. The saving grace was private consumption which remained stable at 4.92% y/y in 1Q, little changed from 4Q's 5.04%. Despite the slow start to the year, our economic team continues to expect growth to accelerate by 5.20% this year with domestic growth doing most of the heavy lifting given that external demand continues to be weak, led by sluggish demand for commodities. This is in line with the recent downward revision to 2016 GDP growth to 5.0-5.4% from 5.2-5.6% previously by the central bank. Government spending remains the key driver of growth given the push for more infrastructure building, and stronger investment, helped by the government's offer of tax breaks to private sector companies that build infrastructure.
- Headline inflation has reversed course and has slipped lower in Apr. After hovering above the 4.0-levels for the past three months, headline line came in at 3.60% y/y in Apr. Driving inflation lower was lower food prices, housing costs and transports costs (due to lower oil prices). Core inflation edged lower again to 3.41% y/y in Apr from 3.50% in Mar, due to softer car prices, and housing rent/contracts. BI maintained their inflation forecast at 3-5% for 2016, while our economic team keeps its headline and core inflation at 3.98% and 3.53% respectively for 2016.
- **Monetary Policy Forecast:** Though the policy rate was left unchanged at 6.75% at its 19 May policy meeting as we had expected, the policy bias is now even more tilted to the downside. In the press conference following the policy decision, the BI governor Agus Martowaradojo said that BI could "ease monetary policy if the room is available and supported by data" as well as stability of the economy needed to be maintained. The governor reiterated this again at another media event, suggesting

that the central bank might loosen monetary policy at its next meeting if global macroeconomic condition remains stable.

- While we continue to expect the easing bias to continue, we do not expect further easing measures to come so soon. This is because the central bank would want to avoid creating any policy-driven volatility during the transition to a new benchmark rate – the 7-day reverse repurchase rate (currently at 5.5%) – and the re-adjustment of the interest rate corridor that would be effective 19 Aug. We believe that the central bank could boost credit growth by other means rather than a rate cut such as loosening lending regulations, including adjusting banks' loan-to-funding ratio and the loan-to-value ratio. Thus, we continue to expect the BI to remain on hold for the rest of the year.
- **Latest Fiscal and External Balance Outlook:** It was reported that government is optimistic that budget spending can reach IDR60.48tn in 1H 2016 or about 30% of FY 2016 target of IDR201.6tn. The Finance Minister reiterated that the government is proposing new assumptions for the 2017 budget. The new assumptions would include inflation at 3-5%, IDR to average 13650-13900, and growth of 5.5-5.9%. The Finance Ministry intends to control the budget within 1.9-2.5% of GDP for 2017.
- The current account deficit (CAD) narrowed moderately to USD4.67bn in 1Q 2016 or 2.14% of GDP compared to USD5.07bn in 4Q 2015. This was better than the 2.20% BI was expecting and was just a tad off last year's full-year CAD of 2.06% of GDP for 2015. The moderation in 1Q 2016 CAD was due to the larger deficit in the primary income account (-USD7.55bn) that offset the larger surplus in goods and services account (USD2.78bn).The overall balance of payments slipped into a deficit of USD0.29bn in 1Q 2016 as the surplus in the financial account was more than offset by the CAD. The central bank continues to expect the CAD to come in at 2.5% of GDP in 2016, less than the 3.0% of GDP target. Meanwhile, our economic team maintains its 2016 CAD forecast at 2.45% of GDP.
- **Key domestic events and issues to watch**: BI meeting on 16 Jun will be closed watched.
- **Technical Outlook:** It was a bullish month for USDIDR in May. Technicals appear to suggest a continuation of bullish bias. 21 DMA has cut 100 DMA to the upside. Key resistance at 13660 (200 DMA). A break above that could see further upside towards 13761 (76.4% fibo retracement of 2016 high to low) before 14000 (2016 high). Support at 13493 (50% fibo), 13224 (23.6% fibo).

PHP: Policy Divergence To Weigh

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USDPHP	47.00 --	47.50 --	47.80 --	47.50 --

No Change from Previous Forecast

- **Motivation for the FX View:** In the run-up to the elections on 9 May, uncertainty over the outcome of the presidential race sent foreign investors fleeing and the PHP slipped 1.8% against the USD in Apr. Since then, investor confidence has returned and the PHP has rebounded about 0.6% against the USD – the best performer among the ASEAN-majors so far in May.
- The PHP could have been stronger if not for the rising risks of a Fed fund rate move in Jun that stymied the PHP's uptick against the USD. Moreover, the feel-good factor post-elections could fade outflows from the equity market continuing as the reality of administering the country vs. a city hits president-elect Duterte. We remain bearish on the PHP as a consequence.
- The hawkish tone from Fed Chair Yellen's comments recently together with those of her colleagues from the board and regional banks has amplified the policy divergence between the US and economies like the Philippines where policy is biased towards further easing. This divergence in policy suggests a firmer USD ahead that supports a higher USDPHP ahead as foreign funds leave Philippines in search for higher yields.
- Thus, the inflows we saw so far in May could slow and even reverse as a result of policy divergence. So far in May, the positive outcome of the presidential election – peaceful elections, high voter turnout, lack of fraud and violence, and quick concessions to the candidate with the plurality of votes have spurred investor confidence. This has led to a sharp inflow of a net USD210mn of foreign investment into equities in the month-to-date vs. the outflow of a net USD5.4mn for Apr. Similarly, investor confidence was also reflected in the demand for government debt with yields mostly lower by 15.0-117.70bp across most tenors except for the 1Mm, 6M and 4Y. These had been supportive of the PHP so far but could dissipate as investor confidence wanes and global risk sentiments turn soft.
- The transition to a new policy rate on 3 Jun has provided BSP to undertake a defacto monetary easing. The new policy rate – the overnight borrowing rate – will be set at 3%, lower than the current policy rate of 4%. We believe that this should put additional downside pressure on the PHP and lift the USDPHP higher ahead. We expect the BSP to keep policy steady for the rest of the year with this transition, barring external shocks.
- A plus so far has been his appointment of Carlos Dominguez III as Finance Secretary-designate. Market has reacted positively to his appointment, which has imbued more confidence among foreign investors in the ability of the new administration to move the economy forward. This was reinforced when he reiterated that the policies of President Aquino will continue under the Duterte

administration. Similarly, the appointment of Ernesto Pernai, an emeritus professor of economics, as head of National Economic and Development Authority should also gets the thumbs up. Another appointement was Silvestre Bello III – a lawyer and former Justice Secretary as the new Labor Secretary. Still, it must be noted that these gentlemen are over the age of 70 and their lack of youth could work against them down the road. The positions for trade and budget however remains unfilled.

- Despite the initial feel good factor following the election of Rodrigo Duterte as president and his appointment of , we believe this will dissipate as the reality of governing an entire country vs. that of a city hits. He might not find pushing his platform through the Congress as easily as he when he was mayor of Davao City. We may thus still see political risks increase in the days ahead. Our analysis showed that there is a tendency for equities to be sold-off for at least another six months after the elections as a result of the uncertainty surrounding the policies of the incoming president.
- The El Nino weather phenomenon and the possible tapering of overseas remittances from the global slowdown and weaker oil prices could also add downside pressure to the USDPHP. A severe El Nino weather phenomenon in 2H 2016 with the resultant floods and droughts could affect crop output and hence agricultural export earnings and could exacerbate the sell-off in the equity market. In addition, slower remittances due to sluggish global growth particularly in the G3 and lower global oil prices affecting the Middle East, could moderate private consumption, a key driver of domestic economic growth and weigh on the PHP consequently.
- Still, the strong economic fundamentals to date, including persistent current account surpluses and economic growth outperformance, should provide the backstop to a too rapid bounce in the USDPHP. This should help to cap the pair below the 48-figure this year. We maintain our forecast for the USDPHP to end 2Q at 47.000 before climbing higher towards 47.50 by end-3Q and then to 47.80 by end-2016. Thereafter, we expect the pair to settle lower to 47.50 by 1Q 2017 after the uncertainty surrounding the elections dissipates.
- Our monthly **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Philippines improved to 4.3 from 5.0. This improvement could be attributed to improvement in GDP, current account and fiscal risks. This should be supportive of the intrinsic value of the PHP.
- **Growth and Inflation Outlook**: GDP growth expanded strongly in 1Q16 by 6.9% y/y vs. 4Q15’s upwardly revised 6.5% (previously 6.3%), which was within expectations. Lifting growth higher was domestic demand, while external demand remained a drag. Strong government spending (9.9% y/y) and consumer spending (7% y/y) lifted 1Q GDP growth higher. As well, investment spending almost doubled to 23.8% from 4Q15. As for the external economy, import growth accelerated at a faster pace than exports (6.6% vs. 16.2%), tempering the rise in GDP. Growth acceleration is expected to continue into 2Q, likely buoyed by election spending. However, with the transition from the Aquino administration to the Duterte, we could see a slowdown in 2H 2016 as government spending could slow. Nevertheless, given the 1Q16 GDP print, our economic team maintains their growth outlook at 7% for 2016.

- Headline inflation stalled in Apr, rising by 1.1% y/y – the same pace as in Mar. The uptick in food prices (1.6% y/y) and restaurant & miscellaneous cost (2.1% y/y) were more than offset by the decline in housing cost (-1.5% y/y). Even the risks of El Nino and election spending are unlikely to impact consumer prices significantly. The central bank maintained its 2016 inflation forecast at 2.1% and 2017 inflation at 3.1%. Similarly, our economic team expects inflation to average 2% in 2016 based on sustained low fuel prices and modest impact from El Nino.
- **Monetary Policy Forecast:** We do not expect any surprises from the BSP at its next policy meeting on 23 Jun. By that meeting, the central bank would have transitioned to the new monetary policy regime (see below). The overnight borrowing rate will replace the reverse repo rate as the new policy rate. **The new interest rate corridor comes into effect on 3 Jun.** This move to an interest rate corridor is intended to make monetary policy transmission more effective than it is currently. The interest-rate corridor will be narrowed with the overnight lending rate at 3.5% (vs. current lending rate of 6%); overnight borrowing rate at 3.0% (vs. policy rate of 4%); and overnight deposit rate of 2.5% (matching the current SDA rate). Note that when the new policy rate comes into effect, the new policy rate will be a 100bp lower than the current policy rate of 4%. Despite claims by the BSP to the contrary that the “shift doesn’t reflect policy change”, these changes appears to be a 100bp rate cut in disguise. This de-factor rate cut is likely to add downside pressure to the PHP as the change-over date approaches. Once the new regime is in place, it is likely that the BSP will pause to observe the impact of the interest rate corridor on the economy and on money market operations and is unlikely to adjust the rates barring global shocks.
- **Latest Fiscal and External Balance Outlook:** The fiscal deficit deepened in Mar by PHP74.4bn as revenue collection continued to lag spending. Revenue slipped 7.8% y/y to PHP157.8bn while spending rose 23.2% to PHP232.2bn. The fiscal deficit should continue going forward especially in 2Q given elections spending and push forward with more infrastructure project and as revenue collection lag. For 1Q 2016, the fiscal deficit was PHP112.5bn, almost on par with the deficit of PHP121.7bn for the whole of 2015.
- After a strong showing in Mar, the overall balance of payments (BoP) recorded a smaller surplus of USD184mn in Apr vs. USD854mn in Mar. This was likely due to portfolio outflows in the month as well as continued sluggish overseas remittances. In the first four months of the year, the overall BoP deficit was at USD91bn. Despite the deficit so far, the BSP governor expects the overall BoP to reverse to a surplus going forward. He attributed this more sanguine outlook to the good GDP data as well as the buoyancy in financial markets recently. The BSP continues to expect a BoP surplus of USD2.2bn or 0.7% of GDP in 2016.
- Key domestic events and issues to watch: BSP meets on 23 May to decide on policy. More importantly, the new President will be sworn in on 30 Jun at noon.
- **Technical Outlook:** USDPHP retraced some of its early month’s losses. Last seen at 46.75 levels. Momentum and stochastics indicators are not indicating a clear bias. Support at 46.50 (50 DMA), 45.90 (2016 low). Resistance at 46.98 (50% fibo retracement of 2016 high to low). Slight bias towards leaning against strength.

THB: Still Under Downside Pressure

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USD/THB	36.00 (35.50)	36.50 --	37.00 --	37.00 --

Previous Forecast in Parenthesis

- **Motivation for the FX View:** As we had expected, the USDTHB move higher last month was short-lived. After rising by around 0.8% in Apr, the THB has fallen by around 2.0% against the USD so far in May. This was likely caused by market positioning ahead of a possible Fed fund rate hike that could come as early as Jun following hawkish comments by Fed Chair Yellen and her colleagues recently. In addition, the charter referendum expected in Aug could see the re-emergence of political jitters, weighing on investor sentiments. Moreover, seasonal factors can also explain the upmove in the USDTHB. There is a tendency for the USDTHB to climb higher in May.
- Portfolio inflows have been strong in May so far compared to Apr. Month-to-date, foreign funds have purchased a net THB2.69bn and THB22.98bn in equities and government debt in May vs. Apr's outflow of a net THB5.60bn and THB5.32bn respectively. This should have supported the THB but did not. This could be because market has been positioning for short THB in the expectations of a stronger dollar on the back of an expected Fed fund rate hike which could come as early as Jun. This is reflected in the recent Reuters positioning poll results that showed the THB as the fourth most shorted currency in the two weeks ended 26 May.
- Further downside pressure on the USDTHB come from the referendum set for 7 Aug to seek the public endorsement for the new constitution. Political tensions could gradually build and intensify towards the referendum date given the military government's attempt to solidify the military's role in the constitution and limit the role of civilians. There are risks that the tensions could blow up and impact investor sentiments, putting even more downside pressure on the THB.
- We remain convinced that the BoT will stand pat on policy in 2016, barring unforeseen risks to the economy. Rate cuts would not solve the kingdom's export woes as a weak THB to mitigate weaknesses in global demand. Moreover, the policy rate is already at near historical lows and is unlikely to be effective in spurring further lending or investment activities. In addition, the central bank views accommodative monetary policy as complementary to fiscal policy, which should take the lead in supporting the economy. Just as importantly, the central bank is likely to save its limited ammunition for even more averse shocks to the economy that could come either domestically or externally. A possible risk to our policy rate outlook is a rate hike in 4Q 2016 as the economy rebounds by year-end, but this not our base case for now.
- More importantly, we believe that the BoT is not opposed to a weaker THB. This was made clear in its minutes of the 11 May

policy meeting where the central bank noted that "the strengthening of the baht against some of its trading partner currencies during some recent periods might not be as conducive to the economic recovery as it could be". This suggests that the BoT is most likely to resist any strengthening of the THB and could use tools other than interest rates to manage any strengthening of the THB. We could possibly see even greater relaxation of capital outflow rules as the central bank did earlier in Apr to manage the THB.

- USDTHB risks remain to the downside as such and these market developments should see the USDTHB climb higher by end-2Q to 36.00 from 35.50 previously. The pair is then expected to climb even further to 36.50 by end-3Q as the referendum approaches. The pair should settle higher at 37.00 by year-end and into 1Q 2017.
- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Thailand improved to 4.0 from 4.7 underpinned by an improvement in GDP, yield, current account and fiscal risks. This should be supportive of the intrinsic value of the THB.
- **Growth and Inflation Outlook:** 1Q 2016 GDP came in better-than-expected, beating market expectations of 2.8%. 1Q GDP expanded by 3.2% y/y vs. 4Q's 2.8%, driven higher by the boost from government investment spending, rising tourist arrivals and foreign investment. However, growth in domestic demand and exports remained weak. Both are likely to remain weak given rising bad debt levels especially among households and still soft external demand. Nevertheless, the better-than-expected 1Q GDP has provided the NESDB with the cue to revised higher its 2016 growth forecast to 3.0-3.5% from 2.8-3.8% previously. Our economic team is even more optimistic, expecting growth to expand by 4.0% - above market forecast of 3.0% - boosted by government accelerated government spending and infrastructure projects.
- After declining for the past 15 months primarily due to the plunge in global oil prices and its effects, inflation re-emerged, although only marginally in Apr. Headline inflation rose by 0.07% y/y in Apr, owing to higher food prices (1.6% y/y) and less negative non-food CPI (-0.76% y/y). Core inflation was marginally higher by 0.78% y/y in Apr from 0.75% in Mar. Our economic team continues to expect further upside to inflation this year. Our team expects low base effects, improving domestic demand, the impact of the drought on raw food prices, the firmer oil prices and the weak THB to lift consumer prices ahead. Our economic team maintains its headline inflation forecast for 2016 at 2.5% compared to 0.8% for BoT.
- **Monetary Policy Forecast:** The BoT kept its policy rate unchanged at 1.50% at its 11 May meeting for the eight consecutive time. The policy rate remains close to historical lows and there is little need for the BoT to adjust the policy rate for now. We expect the central bank to remain on hold for the rest of the year, though the central bank could still adjust rate if the situation calls for it. The preference of the BoT remains for government spending to do the heavy lifting in boosting growth with monetary policy playing a complementary role. Barring black swan events, we do not expect any rate adjustments in 2016 as the concomitant weakness in the THB from a rate cut is unlikely to be a panacea for the kingdom's export woes. The BoT said that

financial stability risks from search-for-yield behavior continue to warrant close monitoring. This is especially true given the policy divergence that is re-emerging as the US Fed prepares to hike the fund rate as soon as Jun and which has encouraged outflows. A risk to our policy view is the possibility of a rate hike by the BoT should the economy grow at a more rapid pace than expected by both the government and market and this could result in a 25bp hike by the end of the year if growth comes in as expected by our economic team.

- **Latest Fiscal and External Balance Outlook:** Government debt rose by THB7.9bn to THB6.013tn in Mar. In Feb, public debt totaled THB6.005tn or 44.13% of GDP. Most of this debt though was owed to local entities. Of the total debt, 94.1% or THB5.66tn was local.
- The current account surplus narrowed to THB174.5bn in Mar from Feb's THB263.5bn surplus. The narrower surplus was due to a more moderate trade and income surpluses of THB165.2bn and THB9.3bn in Mar respectively (Feb: THB212.8bn & THB50.7bn). The overall balance of payments (BoP) though remained in a surplus of THB111.3bn but this was narrower than Feb's surplus of THB216.1bn.
- **Key domestic events and issues to watch:** BoT meets on 22 Jun to decide on policy.
- **Technical Outlook:** USDTHB traded high over the past month. Pair was last at 35.72 levels. 21 DMA is cutting 100 DMA to the upside - an indication of upside bias. Weekly momentum and stochastics are also coherent with the bullish signals. Pair was last at 35.70 levels. A break above 35.77 (61.8% fibo retracement of 2016 high to low) puts next resistance at 36 levels (76.4% fibo) before 36.40 (2016 high). Support at 35.57 (50% fibo), 35.37 (38.2% fibo).

INR: Technical Retracements

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2016
USD/INR	66.80 (65.80)	67.50 --	68.00 (66.00)	68.00 (67.00)

Previous Forecasts in Parenthesis.

- **Motivation for the FX View:** May had indeed been a weak month for the INR before the retracement in the past two sessions. USDINR was last seen around the 67-figure (27 May), awaiting more cues from the Fed. Technically, the current retracement has some way to go but we anticipate further weakness in the currency on firm price pressures, restraint in the RBI to lower repo rate in Jul and a resurgent dollar. As of 25 May, foreign investors sold around U$1.177bn of debt for the year so far as RBI nears the bottom of its easing cycle. USDINR is especially sensitive to Fed hike expectations and the lead up to a potential rate hike in Jun should translate to upside risk in this pair. That said, we are not looking for particular dollar strength and see upside risks in USDINR as opportunities to sell into.

- Fundamentally, the currency is still attractive based on growth differentials with regional peers. However, forward looking reports like the Nikkei PMI-mfg for Apr flagged cautious outlook for the industrial output. In addition, oil prices have been on the rise and that could also be slightly negative for the rupee. In the medium term however, oil prices should be capped and that should keep a lid on inflation pressures. That should provide RBI time to tackle "agflation" and savings from oil prices could be re-invested into the agriculture sector. In a global environment of low rates, rupee is high yielding and that gives it an extra edge over regional peers, especially in episodes of better risk appetite.

- **Our Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for India deteriorated to 5.3(with 1 being the best score and 9 being the worst) from previous 4.6 due to a significant deterioration in its fiscal score relative to peer.

- **Growth and Inflation Outlook:** High frequency data suggests that domestic activity has weakened. Industrial production slipped to just 0.1%y/y from previous 2.0%, well under the expected 2.5%. PMI-mfg dropped to 50.5 for Apr from previous 52.4. New business inflows were little changed although new exports orders continued to rise. In the meantime, input cost inflation accelerated to the fastest since May 2015 during Apr but the pace of selling prices were broadly modest. Outlook seems to have become more cautious as producers have started to draw on their inventories. The output of eight infrastructure industries picked up pace to 6.4%y/y from 5.8%.

- The external sector remained weak with another decline for imports by -23.6%y/y in Apr, a larger contraction than the previous -21.6%. Imports fell by 6.7%y/y, a steeper decline compared to Mar's -5.5%. We continue to look for fiscal efforts in the rural sector and manufacturing to boost consumption and investment.

- Apr CPI quickened to 5.39%y/y from previous 4.83% on higher costs of food, rent and prices of services. Wholesale prices surprised to the upside at 0.34%y/y vs. the expected 0.23% on the back of food component. The electronics component quickened to 0.56%y/y from 0.11% previously.

- The industrial outlook survey conducted for the last quarter of 2015 (Jan-Mar) reveals "moderate increase in optimism for production, order books, financial situation and salary" compared to the quarter prior. However, sentiments on other indicators including exports, imports, employments, profit margin and overall business situation deteriorated. We expect household consumption will continue to be a strong pillar of support while the government and central bank strive to crowd in private investment with reform measures.

- **Monetary Policy Forecast:** The Reserve Bank of India will make its next rate decision on 7th Jun and we expect no move by the central bank given the recent upside surprise in CPI for Apr and we anticipate an extended pause by the central bank ahead of Monsoon period which starts in Jun. RBI lowered repo rate by 25bps from 6.75% to 6.5% in Apr in order to encourage private investment. Whilst cost pressures have edged higher, CPI is projected to "decelerate modestly" and remain around 5% over 2016-17.

- What took the market by surprise was the fact that the central bank tightened the policy rate corridor from +/-100basis points to +/-50bps by lowering the marginal standing facility by 75bps and increasing the reverse repo rate by 25bps such that the reverse repo rate was adjusted to 6.0%, the repo rate was adjusted to 6.5% and the marginal standing facility rate is now cut to 7.0%.

- RBI aims to ensure that the weighted average call rate is better aligned with the repo rate to improve the transmission mechanism of the monetary policy. The move to narrow the interest rate corridor would not have been possible without the variable rate reverse repo auctions that enable the central bank to absorb short term liquidity from the system. This variable rate reverse repo auctions have been in place since 2014. **This move is a show of confidence that RBI has a firm control of the liquidity conditions. The central bank also does not see a need to keep the system in "significant average liquidity deficit" and wants to shift "position closer to neutrality".**

- **Latest Fiscal and External Balance Outlook:** Foreign investors bought USD119.7mn of equities and sold USD987.2mn of bonds in May as of 25 May. Sentiments had indeed become cautious as Fed signals a potential hike while market players anticipate a near bottom for RBI's easing cycle.

- India's fiscal targets were held steady at 3.5% for FY16/17. The government highlighted "Transform India" that is meant to boost domestic demand, continue the pace of economic reforms and policy initiatives. There was also focus and budget allocation for agriculture and farmers' welfare - Irrigation projects will be sped up, a dedicated Long Term Irrigation Fund will be created as well as programme for sustainable management of ground water resources. There is also a substantial amount allocated to education and health care, as well as infrastructure and investment. Total expenditure projected to be INR19780bn – INR14280bn of which is non-plan and INR5500bn is plan. The plan and non-plan classification will be scrapped in the next fiscal year.

- Current account deficit narrowed slightly to $7.1bn in the quarter ending Dec from the previous $8.7b due to the better performance of net exports of goods (-U$34.0bn vs previous U$37.4bn) and greater net current account services surplus at USD18bn.

- **Key domestic events and issues to watch:** India has May PMI-mfg due on the 1st. RBI decides on repo rate on the 7th. Apr industrial production is due on the 10th. May trade is due anytime within 10-15th. CPI for May is due on 13th followed by WPI on 14th. WPI is due on the 16th. 1Q BOP current account balance will be released anytime within Jun.

VND: Watch for Volatility In Jun

Forecast	2Q 2016	3Q 2016	4Q 2016	1Q 2017
USD/VND	22300 --	22600 --	22800 (22400)	22800 --

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The pair steadied for much of May before inching higher towards the end of May on the back of dollar strength and as SBV relaxes dollar lending rules. Last seen around 22410, SBV loosened the curbs on USD lending recently, allowing local banks and subsidiary of foreign banks to lend dollar loans to export companies until the end of the year. Into Jun, we anticipate further potential volatility as markets continue to price in dollar strength amid a potential hike by the Fed. While there is room for dong weakness in the face of potential dollar rebound, we anticipate dollar strength to be limited in the near-term and that could mean USDVND upside moves could remain capped. Beyond the Jun Fed meeting, USDVND could still trend towards 22300 by the end of the month as we anticipate sell USD on rallies.

- Medium term, Vietnam continues to benefit from the Trans Pacific Partnership and the key sector to get the boost is its apparel, footwear, agro-forestry and seafood industry. However, benefits in terms of export earnings could only be felt as early as end 2016 as the agreement has to be ratified by member countries and political obstacles in US, Australia and Canada may delay the process. In the meantime, foreign direct investment continues to surge (into Vietnam as foreign invested enterprises strives to raise their capital and production capacity. That could continue to strengthen the VND.

- Given our expectations for limited dollar strength, Fed hike in Jun, we still see USDVND at 22300 for 2Q. We also take into account resilience exhibited by VND and less depreciation for VND towards 22800 by the end of this year.

- **Growth and Inflation Outlook:** Industrial production saw slight deceleration to 7.8%y/y in May from previous 7.9%, supported by the manufacturing and the electricity output. This followed the rather upbeat PMI-mfg report for Apr which jumped from 50.7 to 52.3 on steeper rise in output and new business.

- Retail sales quickened to 9.1%y/y in Jan-May from 8.8 % in Jan-Apr, underpinned by strong performance in trade and services. Trade balance swung into deficit for May of around U$400mn from a surplus of U$277mn. However, details were less gloomy. Exports growth improved to 6.6%y/y in Jan-May from 6.0%y/y for Jan-Apr. Imports bill shrank less by -0.9 %y/y (Jan-Apr) from previous -1.2% for Jan-Apr. FDI surged 150%y/y in May after a temporary deceleration to 90% in Apr.

- CPI sped to 2.28%y/y in May from 1.9% in Apr, firmer than expected. Higher price pressures in food underpinned the headline. Despite the higher food costs, low energy costs have capped inflationary pressures and keep the CPI near historic low levels.

- **Monetary Policy Forecast:** SBV relaxed its curbs on dollar lending one month after it came into effect. The new daily USDVND fixing has provided stability for the currency since the start of the year. However, that was in a period of dollar weakness. The real test is ahead, into Jun, when we expect the Fed to raise rates and more dollar resurgence. In addition, the allowance for dollar lending to export companies might mean further upsides for USDVND ahead.

- As we expect more volatility for the exchange rate, we do not expect any rate move in the near-term (currently base rate at 9.0%, refinancing rate at 6.5% and discount rate at 4.5%).

- **Latest Fiscal and External Balance Outlook:** While monetary policy targets business funding cost, we hold our view that fiscal policy will be used to boost private and public consumption. We eye more infrastructure projects. Inflation is capped at 5% and the budget deficit capped at 4% of GDP. According to our Vietnamese analyst Le Hong Lien, fiscal expenditures have been outpacing that of revenue in recent years and could be reined in with the recent revised Budget Law meant to take effect from FY2017 that could guide the fiscal deficit below 4% of GDP from 5% in 2015. Our analyst is also of the view that it is in the interest of the Communist Part of Vietnam to continue with the implementation of Vietnam's structural reforms.

- Whilst Vietnam's external balance is expected to weaken this year on weaker exports, growth of exports remain positive for the past five months at around 6.0%y/y and that speaks volume of its competitiveness given the high base and sluggish external demand that has impacted most of the region. Current account recorded a surplus of USD1.077bn in 4Q (latest data available). The expected deterioration on the external front was a key reason for us to expect an approximate 3% depreciation in the VND. However, the amount of foreign direct investment has surpassed our expectations and we now expect less than 2% depreciation in the dong within the year. Looking ahead, expect FDI growth to maintain pace including the second thermal power plant in Vietnam that requires an estimated $1.5bn of investment.

- **Key Domestic Events and Issues to Watch:** May PMI-mfg is due on 1 Jun. Jun CPI is due on the 24th. Trade balance, retail sales and industrial production for the same month will be released anytime within 25-31 May, along with 2Q GDP.

FX Forecasts

	End Q2-16 f	End Q3-16 f	End Q4-16 f	End Q1-17 f
USD/JPY	110	114	116	120
EUR/USD	1.13	1.15	1.12	1.11
GBP/USD	1.45	1.48	1.48	1.52
AUD/USD	0.72	0.70	0.72	0.70
NZD/USD	0.6650	0.6600	0.6700	0.6700
USD/SGD	1.3800	1.3850	1.3900	1.3950
USD/MYR	4.05	3.95	4.00	4.00
USD/IDR	13600	13300	13150	12950
USD/THB	36.00	36.50	37.00	37.00
USD/PHP	47.00	47.50	47.80	47.50
USD/CNY	6.55	6.50	6.55	6.50
USD/HKD	7.80	7.80	7.80	7.80
USD/TWD	32.40	32.40	32.40	32.80
USD/KRW	1177	1167	1200	1180
USD/INR	66.80	67.50	68.00	68.00
USD/VND	22300	22600	22800	22800
SGD Crosses	**End Q2-16 f**	**End Q3-16 f**	**End Q4-16 f**	**End Q1-17 f**
100 JPY/SGD	1.255	1.215	1.198	1.163
EUR/SGD	1.559	1.593	1.557	1.548
GBP/SGD	2.001	2.050	2.057	2.120
AUD/SGD	0.994	0.970	1.001	0.977
NZD/SGD	0.918	0.914	0.931	0.928
SGD/MYR	2.935	2.852	2.878	2.867
SGD/IDR	9855	9603	9460	9283
SGD/THB	26.09	26.35	26.62	26.52
SGD/PHP	34.06	34.30	34.39	34.05
SGD/CNY	4.746	4.693	4.712	4.659
SGD/HKD	5.652	5.632	5.612	5.591
SGD/TWD	23.48	23.39	23.31	23.51
SGD/KRW	852.90	842.60	863.31	845.88
SGD/INR	48.41	48.74	48.92	48.75
MYR Crosses	**End Q2-16 f**	**End Q3-16 f**	**End Q4-16 f**	**End Q1-17 f**
EUR/MYR	4.577	4.543	4.480	4.440
JPY/MYR	3.682	3.465	3.448	3.333
MYR/HKD	1.926	1.975	1.950	1.950
MYR/CNY	1.617	1.646	1.638	1.625
GBP/MYR	5.873	5.846	5.920	6.080
AUD/MYR	2.916	2.765	2.880	2.800
NZD/MYR	2.693	2.607	2.680	2.660
MYR/IDR	3358	3367	3288	3238
MYR/INR	16.49	17.09	17.00	17.00
MYR/KRW	290.62	295.44	300.00	295.00
MYR/PHP	11.60	12.03	11.95	11.88

Source: Maybank FX Research as at 31 May 2016. *These forecasts are meant to be indicative of FX trends and not meant to be point forecasts.

Disclaimers

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