Maybank

Macro | FX Research & Strategy

Global

FX Monthly

2018, Issue 5: Watchful of Fed, Italy and EM Vulnerabilities

What Has Changed This Month?

- We lowered the forecasts for EUR, GBP, CNY, INR, SGD, MYR, PHP and KRW; raised forecast for JPY, in light of recent development including political situation in Italy, recent EM sell-off, lack of progress with EU-UK negotiations and renewed fears of trade wars between US and China.
- In particular, we see yuan recovery against the USD to lag that of other major trading partners as China claws back its currency competitiveness to buffer against external demand amid the trade dispute vs. the US.

Our Strategies

- Our call in the last FX Monthly for bouts of USD strength came to fruition. This can be attributed to a number of factors including the sharp rise in UST yield and USD triggering the sell-off in EM FX and Italian political situation which favor risk aversion flows (i.e. USD. JPY and CHF) as well as data divergence between US and other developed nations, including EU, UK.
- Into early part of Jun, we look for potential pullback in the USD. Recent price-related data out of US and Fed Minutes reinforced our view that current pace of Fed's monetary policy normalisation remains appropriate. Markets positioning for Fed to quicken its pace of normalisation may be disappointed and this could see USD gains unwind. We should expect to see some volatility and accompanying bouts of UST and USD strength in the lead up to FoMC meeting on 14th Jun.
- Into the medium term, higher energy and commodity prices as well as tightness in labor market in other developed world including UK, AU and EU should feed through to inflation and brings back the case of policy convergence at a later stage. This scenario would see other currencies' strength play catch-up. We see opportunities to buy EUR, AUD and GBP on dips.
- We are cautious of a perfect storm (<u>a risk factor and not our baseline scenario</u>) - a lethal cocktail of higher yields (in the event that Fed signals quicker pace of tightening), extended sell-off in EM assets, contagion effect of Italy political crisis and oil price volatility pick up - this will favor safe-haven plays including long in USD, JPY and CHF. In the event of extended sell-off in EM assets, not all EM FX will be affected equally. SGD, KRW and MYR could be more resilient than other EM FX due to strong and rising current account surpluses.
- As tactical plays, we favor short CNHINR and short AUDNZD, targeting objectives at 10.20 and 1.0750 objectives.

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FX Forecast Revision

Upward	Downward
JPY	EUR, GBP, CNY, INR, SGD, MYR, PHP KRW,

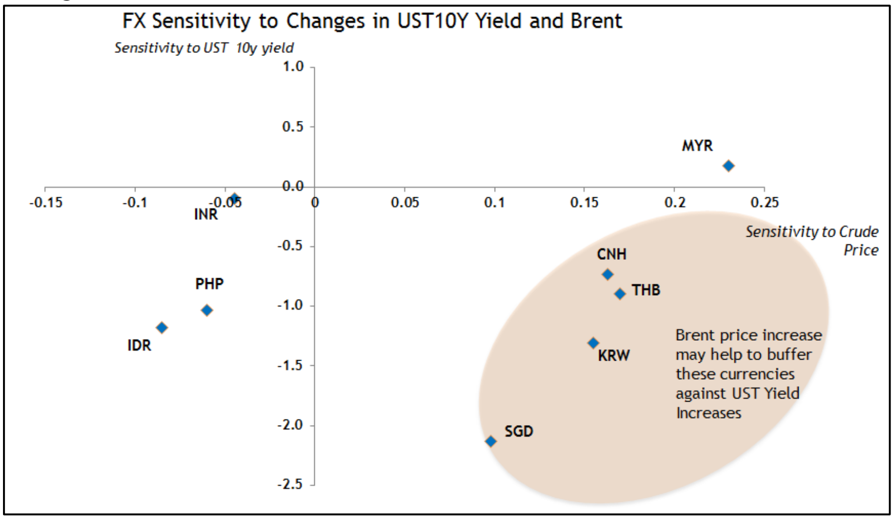
Top 3 Currency Plays for Jun

- Bias to Buy EUR on dips towards 1.14-1.15 levels for move towards 1.25
- Accumulate AUD on dips towards 0.75
- Short CNHINR and AUDNZD targeting 10.20 and 1.0750 objectives, respectively

Key Events for the Month Ahead

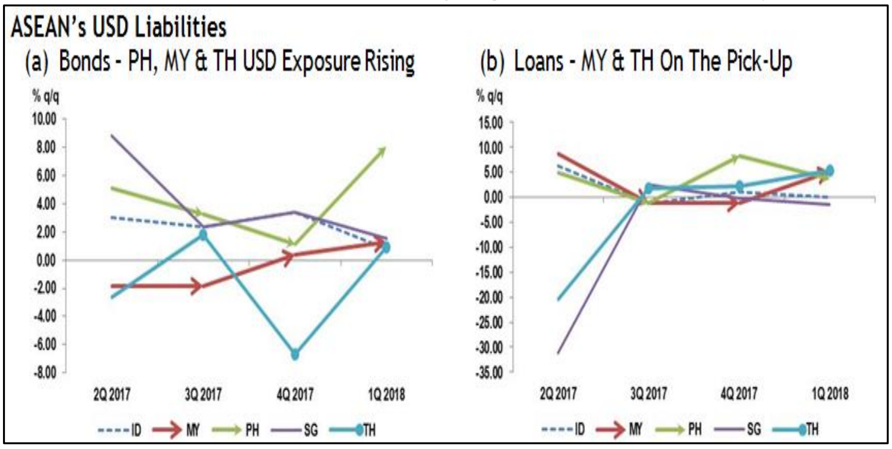
Date	Event
31 May - 3 Jun	G7 Finance Ministers and Central Bank Meet in Whistler, Canada
12 Jun	North Korea- US Summit
13/14 Jun	FOMC Meeting
14 Jun	ECB Meeting
22 Jun	OPEC Meeting
28/29 Jun	EU Summit in Brussels

IDR, INR and PHP Vulnerable in Environment of Rising Oil Prices and Rising UST Yields



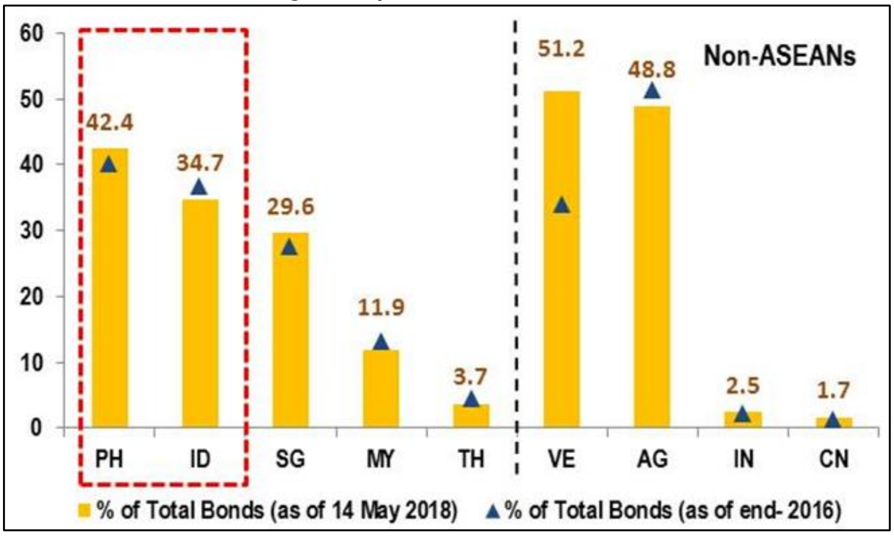
Note: Regression on log values between XXXUSD and Brent and regression on change between XXXUSD and 10Y UST yield (1 year daily data)
Source: Bloomberg, Maybank FX Research & Strategy

PH, MY and TH have Seen Increasing Exposure to USD Liability



Source: Bloomberg, Maybank FX Research & Strategy

PH and ID Have the Largest Exposures to USD-denominated Debt



Note – ASEAN refers to Indonesia (ID), Malaysia (MY), Philippines (PH), Singapore (SG) and Thailand (TH), while the non-ASEAN refers to Venezuela (VE), Argentina (AR), China (CN) and India (IN). Data as of 14th May 2018.
Source: Bloomberg, Maybank FX Research & Strategy

G7 Global Overview

USD: US Inflation, Italy Woes and Trade Tensions Matter

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USD Index	94.03 (90.57)	92.14 (89.18)	90.28 (87.42)	89.37 (86.81)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USD index was revised higher due to downward revisions to EUR (Italian political uncertainty), GBP (lack of progress in negotiations with EU and threat to PM May's leadership) and JPY (potential return of risk aversion).

- USD downtrend is likely to remain in place for second half of 2018 but we do not rule out bouts of USD strength like what we had witnessed in the past few months. We do remain wary of more bouts of USD strength (as previously cautioned) that could emanate from a few scenarios - 1) trade war escalation; 2) inflation pick up – price pressure is still subdued but sustained global recovery could stoke demand-pull inflation and a global bond rout; 3) markets to re-price a more aggressive tightening trajectory as the Fed becomes more hawkish under the new Chair Powell; 4) US fiscal and debt issues could lead to more issuance; 5) Italian political uncertainty affecting risk aversion or flight to quality flows into US and global AAA assets with better credit rating, supporting USD among others. These could in turn trigger another sell-off in global bonds and correction in riskier assets. However, despite the rise in US libor, widening of libor-OIS spread (partially attributable to surge in funding needs for US Treasury owing to Trump's fiscal measures) could potentially moderate when 1) US funding requirements slows and US Treasury receives tax receipts. This could lead to a less tight global funding market and typically weigh on the dollar; 2) The peak in earnings growth and over-shooting on the bond front could lead to some volatility in the equity market and eventually potentially lead to some moderation in any bond sell-off.

- That said we believe broader term shifts were already underway to support the case for broad USD downtrend, including (1) US tax reforms and its wider implication on deficit, debt and the USD; (2) reserve diversification away from the USD; (3) USD countercyclical play; (4) USD downtrend cycle.

- Synchronous global economic recovery, led by US, EU remains intact and it may be too soon to judge if recent inflation upticks could gather pace sustainably to warrant a shift for faster pace of rate hikes. As such we maintain our bias for broad USD downtrend and look for opportunities on USD upticks to fade into. We believe that a slightly faster pace of tightening amid healthy economic growth outlook and optimistic corporate earnings outlook should not derail the growth momentum or USD down-trend. That said the interim risk-off sentiment could remain as markets adjust from a period of policy certainty under Yellen's era to a period of policy uncertainty under a new leadership (Powell).

- To add further on the USD inverse relationship with global trade and economic growth is that a large share of international trade is transacted in USD even when the US itself is not the party to the transaction. This suggests that world trade volumes are driven in large part by USD. Appreciation in the USD crimps demand for US exports but also for all USD-denominated exports.

- Upcoming June geopolitical events which could affect Fed risks in June summit between President Trump and North Korean leader Kim Jong-Un. Overall, if by mid June, oil prices rise sharply, and if there is a significant escalation of US-China trade tensions and a failed attempt at greater stability on the Korean Peninsula – we could see higher financial volatility and eventually some effects on global growth with impact on the USD upside being constrained and bond yields falling. There could also be a risk of a Fed pause in June meeting on the back of softer price data and external market volatility, which may soften the USD

- **Growth and Inflation Outlook:** US real GDP increased 2.2% y/y in the 1Q 2018 instead of the previously reported 2.3 % pace. Market participants had expected first-quarter GDP growth would be unrevised at a 2.3 percent pace. In 4Q2017, real GDP increased 2.9%. The general picture of economic growth remains the same; downward revisions to private inventory investment, residential fixed investment, and exports were partly offset by an upward revision to nonresidential fixed investment. But US GDP growth slowed slightly more than initially thought in 1Q amid downward revisions to inventory investment and consumer spending, even as income tax cuts are likely to boost activity this year. There are signs GDP growth gathered momentum early in the second quarter, with solid consumer spending, business investment on equipment and industrial production in April. But the housing market appears to have taken a further step back. Market participants expect a $1.5 trillion income tax cut package, which came into effect in January, will spur faster economic growth this year and lift annual GDP growth close to the Trump administration's 3% target.

- U.S. inflation took a breather in April from its acceleration in recent months. Excluding food and energy, the core consumer price index was up a below-forecast 0.1 percent from March, the least since Nov, after 0.2% the prior month. The 2.1% annual increase was also lower than projected and the same as in March. Dragging down the measures were the biggest monthly drop since 2009 for used cars and the largest decline in airfares in four years. Including all items, the CPI picked up to a 2.5% increase from a year earlier after a 2.4% gain in March, due to rising gasoline prices. The core CPI reading brought the three-month annualized gain to 1.8%, the lowest since July, after 2.9%. The shelter category rose 0.3% from the prior month after a 0.4% gain. Owners-equivalent rent, one of the categories designed to track rental prices, advanced 0.3%. Hotel and motel rates, which had posted an outsize gain in March, rose 0.8% in April.

- **Monetary Policy Forecast: We maintain our outlook that further progress toward the Fed's mandate will keep the FOMC on a path of gradual policy normalization. We expect the next 25bp increase in the target funds rate to occur as early as June or 2H 2018 with a total of 3 hikes this year.** Fed funds rate (FFR) was raised by +25bps to 1.50%-1.75% at the first FOMC meeting chaired by Jerome Powell in March 2018. No change in Fed's guidance of three rate hikes this year, with a likely June move followed by one or two more hikes for the rest of the year in 2018. Fed signalled one additional hike each in 2019 and 2020.
- Fed Minutes was released on 24 May. It was perceived to be slightly dovish leaning. Though a rate hike in Jun is expected, the minutes did not show hints of Fed quickening their pace of tightening. Instead the mention of "a temporary period of inflation modestly above 2 percent would be consistent with the committee's symmetric inflation objective" suggests Fed's tolerance in the event of inflation overshooting its target. In addition the minutes also noted that the spread of the IOER over effective Fed fund rate had narrowed to only 5bps. A technical adjustment of the IOER is expected at the next meeting when the Fed is expected to tighten. Fed mentioned that this can be accomplished by implementing a 20bps increase in IOER at a time when the FoMC raises the target range by 25bps. This technical adjustment serves as a calibration exercise rather than an accommodation but does suggest that the Fed is taking steps to ensure that the effective fund is in the middle of the target range rather than skewed closer to the upper range. Yields of shorter tenors of less than 1Y USTs have fallen slightly.
- Fed kept policy rate unchanged as widely expected at the FoMC meeting overnight. But accompanying statement contained tweaks pertaining to their assessment on inflationary trends - acknowledged that inflation on a 12month basis is expected to run near the committee's symmetric 2% objective over the medium term. This statement replaced the previous one where it said that inflation is expected to move up in coming months and to stabilise around the 2% objective. Fed went on to reiterate that further gradual increases in fed fund rate will be warranted and is likely to remain for some time below levels that are expected to prevail in the longer run. We believe Fed's slight revision on inflationary trends is to pre-empt market that further CPI upticks are likely but the Fed will also be tolerant of inflation temporarily overshooting the 2% symmetric objective. Temporary deviation is not likely to trigger the Fed to quicken its pace of monetary tightening. Gradual pace of rate increases remains - stay the course. We maintain our call for Fed to raise fed fund rate by 25bps at the Jun meeting.
- **Latest Fiscal and External Balance Outlook:** The "Tax Cuts and Jobs Act" (TCJA) was signed into law on Dec 22, 2017. Although the tax policy left out many controversial overhauls that have been put forth, the final reconciled bill between the House and the Senate still saw major reforms including corporate tax cuts to 21% from 35% and one-time tax repatriate of earnings and profits at 15.5% and 8% for reinvestments (further details are outlined in Appendix 1 at the end of

this report). These tax reforms will have implications on broader economy, politics and the US Dollar.

- Briefly on the economic front, the TCJA is expected to increase US GDP by 0.8% in 2018, reduce marginal tax rates and increase personal consumption. Output and aggregate demand will be lifted, hence boosting government revenue, according to Tax Policy Center's (TPC) analysis on macroeconomic effects of tax reforms.
- On the tax reforms' implications on FX, it is not as clear cut. The one-time repatriation could lead to demand for USD. In the current episode that is unfolding, tax reforms is expected to widen US budget deficit to -5.4% of GDP (vs. -3.4% currently) while debt to GDP will rise to 97.5% of GDP (vs. 75% of GDP currently), according to Congressional Budget Office (CBO) estimates.
- And if history is of any guide, the current period of tax reforms (widening budget deficit and rising debt to GDP) is akin to expansionary fiscal policies and like previous periods, the USD should weaken.
- **Key domestic events and issues to watch in June 2018:** ISM Mfg (1 June); FOMC (14 June); Factory orders and Durable Goods Orders (4, 27 June), NFP (1 June); CPI (12 June); Retail Sales (14 June); FOMC Meeting Minutes (24 May); GDP 1QT (28 June); Core PCE (28 June); PCE Deflator (29 June).
- **Technical Outlook:** USD extended its rebound for the second month in a row, with DXY tested 6-month high of 95 levels (29 May). DXY was last seen at 94 levels. Bullish momentum on weekly and daily charts is waning while stochastics is showing signs of falling from overbought conditions. Price action shows a bearish engulfing candle on the daily chart and potentially a break out of rising wedge formation (formed since mid-May). These signals suggest the potential of a pullback. Support at 93.40 (21 DMA), 92.80 (38.2% fibo retracement of Apr low to May high). Resistance at 94.2, 95.2 levels. Possibly see DXY starting Jun of a softer note before rebounding into FoMC meeting.

EUR: Pressured Lower by Heightened Political Stress

Forecast	2Q 2018	3Q 2018	4Q2018	1Q2019
EURUSD	**1.1700** (1.2500)	**1.1900** (1.2800)	**1.2200** (1.3000)	**1.2400** (1.3000)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** EUR weakness since mid-Apr is likely to persist despite dimming prospects of anti-establishment parties (Five Star Movement and Lega Nord) forming a euro-skeptic coalition government. Calls for protests (on 2 Jun) and re-elections (as early as Sep) will heighten political uncertainty and weigh on EUR. Though there were comments from ECB officials that they are not ruling out the possibility of moving towards a wind-down in stimulus as early as Jun, we think it may be too early to commit at this stage given the ongoing political mess in Italy which shows no apparent signs of abating. A technical rebound in the EUR towards 1.17 levels in the short term is not unexpected given stretched selling but rally may not be sustainable as markets shift into “sell-on-rally” mentality. We think further extension of the decline towards 1.1450 is not impossible on: (1) political situation in Italy is far from certain (potentially a re-election for Italy as early as Sep 2018), (2) Spain’s ruling government may also face fresh elections and (3) ECB’s path of policy normalisation is expected to remain gradual unless inflation shows signs of pick up (a case of monetary policy divergence between ECB and Fed); (4) economic data divergence between Euro-area and US. We lowered our EUR forecasts (much more for 2Q-3Q 2018 than 4Q 2018 - 1Q 2019) to reflect the above-mentioned drivers but maintained a constructive outlook of the EUR in the medium term.

- Political developments in Euro-area remain fluid and will remain a main source of volatility and uncertainty for EUR in the next few months. Risk of contagion effect to other Euro nations is not ruled out if BTP-German and Spain-German spreads continue to widen. Euroscepticism spilling over from Italy could undermine the stability of the Euro-area bloc and weigh on EUR while fresh elections in Spain could also add to EUR weakness:

    – At time of writing (28 May) for Italy, President Mattarella vetoed the euroskeptic’s choice of Economy Minister (Paolo Savona) and PM-designate Prof Conte (candidate chosen by leaders of Five Star Party and Lega Nord) has given up his bid to form a government. As a temporary stopgap measure, former IMF Economist Carlo Cottarelli (picked by President Mattarella) could potentially take over as a non-populist PM to form an interim administration before calling for a re-election in 1H 2019. But the likelihood of a re-election earlier than expected has risen given the failure for Five Star Movement and Lega Nord to form an anti-establishment coalition government. Talk of 29 Jul or 9 Sep as possible dates for re-election in Italy (if there is). Previously there were concerns of potential fiscal mismanagement and Italy breakaway from the Euro associated with the proposed formation of anti-establishment coalition government. Though not finalized, there were chatters on plans to review EU fiscal rules and bail-in rules, seek guaranteed minimum income for poorer Italians, cut tax rate for companies and individuals and roll back pension reforms which could come at the risk of derailing previous years of fiscal discipline. 10Y BTP-Bund spread had widened to levels not seen in a year of +205 bps (25 May) after Moody puts Italy's debt rating on review for downgrade but spreads have eased slightly to +190bps (28 May) after euro-skeptic parties failed to get the green light from President Mattarella to form a coalition government.

- Spanish equities and government debt came under pressure (25 May) after reports that the ruling Centre-right party (led by Rajoy) may face fresh elections. 2 Opposition parties (Spanish Socialist Workers' Party and Liberal Ciudadanos Party called for motions of no-confidence against the government in response to a court ruling in a graft case involving members of the ruling Centre-right party. 10Y Spanish-Bund spread widened to +111bps, highest level not seen since early Jan this year. Uncertainty in the political space here will add to EUR weakness.

- On a broader term perspective into 4Q 2018, we remain constructive of EUR's outlook on (1) expectations of political risks in Italy and Spain to recede gradually; (2) sustained signs of growth momentum in Europe (though growth cycle may have picked), supported by private consumption, business sentiment, construction investment, sizeable current account surplus (3.5% of GDP) and export recovery; (3) ECB's gradual pace of policy normalisation is expected to proceed as planned. These underlying fundamentals should continue to support the case for "buy EUR on dips". Uncertainties in the political space will weigh on EUR in the short term (up to 3 months) and this interim weakness may present better opportunities on dips (possibly towards 1.12 levels) to buy into. Higher commodity prices globally should feed through to inflation at some stage and bring back the case for monetary stimulus removal from ECB. This should serve to narrow the policy divergence between ECB and Fed and helps support the EUR.

- On the upcoming ECB Governing Council meeting (14 Jun), we expect the Governing Council to keep policy status quo given the political mess in Italy and potentially Spain as well as a lack of meaningful pick-up in inflation in the Euro-area for now. We do however see chance of discussion on the future of ECB's asset purchase program (i.e. if it will be extended after the end of Sep 2018). Currently, APP is proceeding at the monthly pace of €30 billion. We do not expect ECB to commit to a decision ahead of Sep-2018 as inflation remains soft for now and have yet to show signs of re-acceleration. We do not expect ECB to jump the gun ahead of inflation upticks. Slower than expected pick-up in inflation should continue to reinforce expectations for gradual pace of policy normalisation. This is also one factor that should limit EUR upside unless inflation outlook brightens up.

- **Upside Risk to Our Outlook:** EUR weakness could slow and may potentially find upside relief should political uncertainty in Italy subsides: (1) a technocrat government be formed swiftly in Jun without much protests and obstruction from opposition; (2) eventual re-election results in anti-establishment parties (Five Star Movement or Lega Nord) being booted out of favor by the people or a coalition government formed with a moderate (such as PD or Forza) as a partner (to moderate any anti-EU sentiments). ECB normalizing monetary policies (i.e. forward guidance on end of QE to be announced before Sep) could also be supportive of EUR.

- Taking stock, our call for EUR to temporarily stay under pressure on the back of deepening policy and data divergence materialized. The 5% move lower for the past 4 weeks or so exceeded our expectations, with the recent trigger coming from heightened political uncertainty associated with Italy's formation of an euro-skeptic coalition government (before President Mattarella vetoed). This comes amid the backdrop of decelerating momentum with Euro-area data (such as PMI, inflation, industrial production, etc.) which led to fading expectations of ECB policy normalisation. Pair was last seen at 1.17 levels. We do not rule out an extension of the decline towards 1.1450 levels and suggest a relatively wider trading range of 1.1450 – 1.1950 for the month ahead given many events – political uncertainties in Italy and Spain as well as ECB and Fed meetings in Jun.

- **Growth and Inflation Outlook: Euro-area recovery continues with 20 consecutive quarters of growth but momentum shows signs of moderation after consecutive quarters of upside surprises.** 1Q growth slowed to +0.4% (vs. +0.7% in 4Q) on sequential terms. On y/y terms, 1Q growth slowed to 2.5% (vs. 2.8% in 4Q). ECB believes transitory factors such as cold weather conditions, influenza, Easter holidays and industrial strikes were likely to have played a role in the overall slowdown in recent economic indicators. Though PMIs showed signs of moderation in manufacturing and services sectors, they remain in expansionary territories. There are also reasons to believe that the moderation was due to supply side constraints. ECB highlighted that capacity utilisation and backlogs/supply delivery times in the capital goods sector stand at all-time highs while in the construction sector, an increasing number of firms are indicating that a shortage of labour is limiting their production. Unemployment rate at 8.5% (Apr) is now at its lowest level since Dec-2008.

- New set of ECB projections for growth will be released on 14 Jun. As of the last report in Mar-2018, ECB projections for 2018 growth has been revised upwards to 2.4% (vs. 1.9% in Dec-2017 projection) while projections for 2019 and 2020 stay unchanged at 1.9% and 1.7%, respectively. ECB's recent assessment (8 Mar) is that (1) private consumption is supported by rising employment, which is benefiting from past labour market reforms, and by increasing household wealth; (2) business investments continue to strengthen on the back of very favourable financing conditions, rising corporate profitability and solid demand (3) housing investment has improved further; (4) broad-based global recovery is supporting Euro-area exports.

- **Euro-area inflation was largely steady in Apr** (1.2% y/y vs. 1.3% y/y in Mar vs. 1.2% expectations); core inflation also held steady at 0.7% (unchanged from prior read). Underlying inflation remains subdued for now but is expected to rise over time as higher energy prices of late (oil price rose above $70/bbl) is likely to feed through. ECB's monetary policy measures, continuing economic expansion and rising wage growth should also continue to support the case for inflation to return to ECB's 2% target over time. Inflation projection for 2019 was lowered to 1.4% from 1.5% but remains unchanged at 1.4% for this year and 2020, as of the last ECB quarterly assessment in Mar.

- **Monetary Policy Forecast:** We expect ECB to keep the rate of Main Refinancing operations, deposit facility and marginal lending facility unchanged at 0%, -0.4% and 0.25%, respectively at the upcoming meeting on 14 Jun. There were talks that ECB policy makers have not yet ruled out the prospect of moving further toward a wind down of stimulus as soon as Jun (28 May Bloomberg report) – we however think a Jun tweak may be too early as political situation in Italy and Spain remains uncertain while **inflation remains soft for now** and have yet to show signs of re-acceleration. There may be **chance of discussion on the future of ECB's asset purchase program** (i.e. if it will be extended after the end of Sep 2018) but we **do not expect ECB to commit to a decision.** ECB is not expected to jump the gun ahead of inflation upticks. Slower than expected pick-up in inflation should continue to reinforce expectations for gradual pace of policy normalisation

- At the last ECB meeting (26 Apr), ECB GC kept policy rates (Main Refinancing operations, deposit facility and marginal lending facility unchanged at 0%, -0.4% and 0.25%, respectively) and APP (at monthly pace of €30 billion) on hold as widely expected. There was no discussion on monetary policy, in particular how the APP may end. The press conference devoted a fair amount of time on the flow of economic growth data since start of 2018. ECB acknowledged the moderation in the pace of growth but added that moderation may in part reflect a pullback from the high pace of growth while temporary factors may also be at work. He emphasized that ECB will have to monitor the development and try to get a better view on the temporariness of the slowdown. On inflation, Draghi reaffirmed his confidence that inflation will eventually rise to ECB's target of just under 2% even if there are still no convincing signs of a sustained upward trend.

- **Latest Fiscal and External Balance Outlook:** Euro area's current account surplus narrowed to 9-month low of EUR32bn in Mar (vs. EUR36.8bn in Feb). Trade account recorded its smallest surplus in nearly a year. Current account surplus to GDP was last seen at 3.6%.

- The EA19 government deficit narrowed to -0.9% of GDP in end-2017 (vs. -1% of GDP in 3Q). This is the narrowest level since 2008. Breakdown showed German government recorded +1.3% surplus of GDP while deficits were seen for France, Italy and Spain at -2.6%, -2.3% and -3.1 of GDP, respectively.

- **Key domestic events and issues to watch:** May Mfg PMI (1 Jun); Apr PPI, Apr CPI (3 May); May services PMI, Mar retail sales (5 Jun); 1Q final GDP (7 Jun); ZEW survey (12 Jun); Apr Industrial Production (13 Jun); ECB meeting (14 Jun); Apr trade, May CPI (15 Jun); Apr current account, construction output (19 Jun); Jun consumer confidence (21 Jun); Jun Prelim PMIs (22 Jun); Jun consumer confidence (28 Jun); Jun CPI estimate (29 Jun).

- **Technical Outlook:** EUR's sell-off extended in May, with lows seen at 1.1510 (29 May). Italian political crisis was the main culprit. Pair was last seen at 1.1660 levels. Bearish momentum on weekly and daily chart shows signs of waning while stochastics is in oversold conditions. Price action shows a potential falling wedge in the making – this is typically associated with a bullish reversal. We do not rule out rebound risks in the short term. Area of resistance at 1.1690 - 1.1720. Break above this puts next level at 1.1790 (21 DMA). Support at 1.1610, 1.1510.

GBP: Eroded by Cabinet Splits and Brexit Time Decay

Forecast	2Q 2018	3Q 2018	4Q2018	1Q2019
GBPUSD	1.3400 (1.4000)	1.3800 (1.4400)	1.4000 (1.4500)	1.4200 (1.4400)

Previous Forecast in Parenthesis

- **Motivation for the FX View**: GBP's decline since mid-Apr may persist further as UK cabinet splits (on relations with EU after formal exit) is a major impediment to the lack of progress on negotiations with EU on future relationship and a threat to PM May's leadership. Moderation in growth momentum and fading expectation of BoE tightening are other factors weighing on GBP in the interim. We do not rule out a move towards 1.30-1.31 levels over the next few weeks. We lowered our GBP forecasts taking into consideration the time decay (about 9 months to go before formal exit) for UK to negotiate with EU on future relationship and the lack of unity within the cabinet but maintained the forecast trajectory to reflect our optimism for orderly brexit and renewed market bets for BoE to tighten this year.

- **Customs Union vs. Maximum Facilitation:** In the interim, the government remains split on what type of customs deal Britain ultimately wants with the EU. On one hand, majority of Labour party (opposition) is supportive of the customs union while within the Conservatives, there are factions in the party with pro-EU conservatives supporting customs partnership but majority of the Brexit sub-committee (11 members including Sajid Javid, Johnson, Davis, etc.) are against customs union and are calling for maximum facilitation.
    - Customs Union: Also known as the "hybrid model", which UK would collect EU import tariffs for goods bound for EU markets

on behalf of Brussels and pass to EU. This option will avoid the return of a hard border between British-ruled Northern Ireland and EU's Irish Republic.

- Maximum Facilitation: A clean break to quit the single-market and customs union to pursue independent trade deals with other countries. Involves using technology to lower customs barriers (also known as digital borders) by including pre-approved authorized economic operators who are given faster clearance, and pre-arrival notifications linked to customs declarations and vehicle registrations so trucks do not have to stop at borders. Accepts the need for hard borders even for Northern Ireland.

- **Both options are deemed unworkable by the EU** saying that the digital border is untested and unrealistic while customs partnership is too complicated (EU had claimed that London has lost their trust on customs collection). EU has prepared an emergency mechanism which it would continue to regulate trade with Northern Ireland after Brexit

- Though PM May had stated her preference to leave the customs union when they leave the single-market and to strike trade deals around the world, the **issue here is the parliament will have its final say.** So far the **upper house (House of Lords) have voted to retain a customs union** (and inflicted 15 defeats on the EU Withdrawal Bill so far) while the **lower house is expected to vote in early Jun** ahead of the EU Summit (28-29 Jun). The government will need to overturn these amendments when legislation returns to the lower House of Commons. **Pro-EU Conservative members may prefer to stay in Customs Union and rebel against PM May**. This would **expose the awkward divide within her party and pose a threat to her leadership**. An un-united stand within the UK government would make weaken PM May's stance when negotiating with the EU. And these could **expose GBP's vulnerability to further downside**. However GBP may see some support if PM May manages to convince her party of standing in the same line (i.e. to leave customs union). At least this suggests her leadership is not under threat and shows some unity in UK government.

- We maintain our strategic call on "buy dips", on the back of expectation for orderly *Brexit* (now seen as a key source of volatility for GBP) and continued improvement in labor market to pose upward pressure for wage growth providing room for BoE to tighten possibly in 2H 2018. Eventual return of market bets on BoE tightening should support GBP while an agreement internally within the UK cabinet could help to solidify PM May's leadership and help with negotiations with the EU on future trade relationship and other *brexit* matters. These should mitigate *brexit* fear factor and bolster the GBP.

- Nonetheless uncertainty on the above key factors will continue to see a great deal of variability on the exchange rate. A no-confidence vote on PM May's leadership or fresh elections being called could expose GBP to greater downside.

- Into the medium term (12-month), we maintain our bias that GBP could trade higher from current levels towards 1.45 – 1.48 as GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40). The 20% or so depreciation (from Jun to Oct 2016) should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We believe UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term). Past experience of UK leaving the ERM back in 1992 saw a period of consolidation (for a few years) at historical lows for GBP, before the eventual move higher in the following years, where GBP TWI traded above 100-levels in 1998 (from the lows of 80 in 1993-1996) due to buoyant demand fueled by rapid growth of wealth, credit and money. If history is a guide (assuming UK manages the transition well and takes the opportunity to correct its imbalances), its currency may start climbing higher.

- **Growth and Inflation Outlook: 1Q GDP growth slowed to weakest level since 2012** at +0.1% q/q (vs. +0.4% prior). The slowdown can be attributed to shrinking business investments (-0.2%) while household spending recorded its weakest print in more than 3 years (at +0.2%). In terms of sector, manufacturing, services sectors slowed while construction output shrank. These data continues to validate our caution that growth momentum is decelerating and is below its long term average. The OECD leading indicator also indicated easing growth momentum in UK. BoE had weighed in to say that slowdown in 1Q has been severely exaggerated by the bad weather disrupting shoppers and construction work. If this is true, we could possibly see growth and activity rebounding this quarter. Retail sales for Apr did rebound sharply from the slump in Mar. Growth and activity momentum will be closely scrutinized for signs of further rebound. This could bring back market expectations for a rate hike in Aug. We reiterate that decelerating momentum should not be mistaken as downturn. Though Mfg and non-Mfg PMIs were lower than expected or previous prints, they remain in expansionary territories (above 50). Labor market has also continued to tighten with unemployment rate falling to more than 4-decades low of 4.1%. There are also signs that wage growth may gain traction amid tightness of labor market conditions and this could generate domestic price pressures. Wage-squeeze conditions for UK consumer could ease and that should support consumption going forward.

- In that last BoE's Quarterly Inflation Report (10 May), growth for 2Q was revised lower to 1.4% (vs. 1.8% in the last QIR) while inflation was revised lower to 2.4% (vs. 2.7% in the last QIR).

- **UK headline inflation slowed** to 2.4% y/y in Apr (vs. 2.5% in Mar). This is the lowest level in a year and the pace of slowdown exceeded expectations. The biggest drag came from airfares owing to early Easter (in Mar this year) while upward pressure came from fuel and soft drink prices. The reported noted that imported inflation has eased but domestic pressures are building up. Breakdown show communication, recreation and culture, alcohols and restaurants contributing to upside pressure. Despite the overall slowdown in CPI, inflation at current levels remains well above BoE's threshold. The recent increase in oil prices as well as tightness of labor market (likely to generate price pressures) should feed through to inflation at some stage. Our internal forecast on UK inflation trajectory suggests that inflation may have peaked at 3% in 4Q 2017 and is slowly easing towards 2% in 1Q 2019. Core inflation also slowed to 2.1% y/y in Apr (vs. 2.3% for Mar).

- **Monetary Policy Forecast: We expect BoE to keep policy rate unchanged at 0.5% at** the upcoming BoE MPC meeting on 21st Jun as inflation decelerated faster than expected amid concerns on global growth momentum, trade war and brexit uncertainties. OIS futures suggest that the earliest date market is pricing in a BoE rate hike is in Nov (with an implied probability of 52%). We **maintain our call for a 25bps rate hike possibly as early as August**. Unemployment rate falling to 43-year low and signs of real wages rising underscores the tightness of labor market conditions and this could generate domestic price pressures and builds the case for BoE to normalize policies. This is conditional on dissipating fears of Brexit uncertainties.

- At the last BoE meeting (10 May), MPC voted 7-2 to keep policy rate on hold at 0.5% as widely expected. On growth and inflation forecast changes, growth for 2Q was revised lower to 1.4% (vs. 1.8% in the last QIR) while inflation was revised lower to 2.4% (vs. 2.7% in the last QIR). Downward revisions left the impression that rate hike will be delayed. Minutes from the policy meeting acknowledged the weakness of the 1Q GDP and noted there was value in seeing how economic data unfold over the coming months to discern whether the softness in 1Q might persist. Governor Carney reiterated that the softening is a temporary problem due to snowy and icy weather.

- **Latest Fiscal and External Balance Outlook:** UK's current account deficit narrowed to -4.1% of GDP for 2017. This is the narrowest level since 2011, helped by depreciation in GBP. The Office of Budget Responsibility has projected current account deficit to be about -4.4% of GDP in 2021, rather than -2% of GDP initially forecasted in Mar 2017. Foreign inflow of capital is needed to fund the deficit. But if Brexit uncertainty takes a turn for the worse (not our base case scenario) or persists for longer, investor/business sentiment can be adversely impacted. Slowdown in foreign inflows could worsen the situation and the GBP could come under pressure as a result.

- UK public finance started the new financial year on a stronger footing, as budget deficit was smaller than expected. Budget deficit stood at -2% of GDP for 2017/18. This is the smallest budget deficit to GDP since 2001/02. Progress was made on public finances as economy slowed less than feared after referendum result in Jun-2016. Though Chancellor Hammond intends to run a budget surplus by mid-2020s, he did suggest he could announce more spending in his Budget speech in Nov.

- **Key domestic events and issues to watch:** May Mfg PMI (1 Jun); May Construction PMI (4 Jun); May services PMI (5 Jun); Apr trade, IP, construction output (11 Jun); Apr labor report (12 Jun); May inflation (13 Jun); May retail sales (14 Jun); May public finances, BoE MPC meeting (21 Jun); 1Q final GDP (29 Jun). EU Summit in Brussels on 28-29 Jun.

- **Technical Outlook:** GBP's decline continued for a second consecutive month in a row. Cumulatively, GBP has fallen more than 8% from the highs above 1.43-handle to a low of 1.3205. Pair was last seen at 1.33 levels. Bearish momentum on weekly chart remains intact while stochastics is entering oversold conditions. Downside from here could be sticky and limited towards 1.3220, 1.3150 1.3090 levels. Resistance at 1.3390, 1.3540 and 1.3620.

AUD: Watching Inflation

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
AUDUSD	0.7700 (--)	0.7800 (--)	0.8000 (--)	0.8000 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** AUDUSD failed to break above the 0.76-figure and slipped below the 0.75-figure at last sight. The pullback in the UST 10y yield initially saw the AUD head higher but jittery risk sentiments and the mixed base metal prices (iron ore lower, copper higher) curbed the enthusiasm of the AUD bulls. When AUD recovered towards the 0.76-figure, AUD seems poised to head even higher, only to be thwarted by dip in risk appetite, we remain mildly bullish on the AUDUSD from where it is right now (just below the 0.75-figure). The USD could be turning in favour of the AUD soon and we do not want to underestimate the impact of the rise in crude prices on inflation. With AUD and NZD showing more resilience than their G10 peers, we reckon that Australia's AAA bonds are still attractive in times of risk aversion with flight to quality supporting the AUDUSD on dips. With data not entirely supporting our rate hike call in Aug as yet, we see risks to the AUDUSD evenly balanced on both sides. The current slowdown in China represents some downside risks to our AUDUSD forecast but we reckon that the slightest change in RBA stance on monetary policy guidance could trigger some overshooting in the AUD. The latter factor seems to less in the price than the former and we maintain our forecasts at 0.80 at the end of the year.

- We are compelled to maintain our bullish view on the AUD because of the budget as well which could boost consumption and investment. With lower to middle income households receiving a tax rebates of up to A$530 per year from this budget as well as raise in the income threshold for tis tax brackets in FY2019 and FY2020 could boost private consumption. Where RBA is unable to do the heavy lifting, the government seems to have taken over. Along with the infrastructure boost that could also underpin private consumption and investment, we see this as an upside risk to inflation and cash target rate.

- **Growth and Inflation Outlook:** Data released was mostly positive and we remain mildly positive on the economy. We see the rebound in full-time hiring growth as a sign of stabilization from its decline in the past few months. Retail sales edged higher to 3.1%y/y for Mar from previous 3.0%. On the month, there was no growth in retail sales. However, tax rebates for lower to middle income households that came in the federal budget could support private consumption. Capacity utilization rates are still high historically and that is a sign of slack decreasing. However, industrial profitability in China has been coming off and we see that as a downside risks to the AUD. Expect 1Q GDP growth to be rather healthy with strong contribution from net exports but this data is retrospective and is unlikely to move the AUD significantly.

- From the release in Apr, 1Q CPI came in roughly in line with expectations with headline steady at 1.9%y/y, undershooting the consensus around 2.0%. Trimmed mean at 1.9%y/y, firmer than the expected at 1.8% and CPI weighted mean was also around 2.0%. Putting them together, the underlying inflation is around 1.95%y/y, firmer than the expected around 1.85%. That is still well under the "mid of 2-3% inflation target range" that Lowe prefers in order to move the cash target rate.

- **Monetary Policy Forecast:** It is highly unlikely that RBA would show any indication of raising cash target rate in the meeting next Tue (5 Jun). To be sure, RBA has remained sanguine on growth prospect enough to keep the discussion on future monetary policy action centered on hikes. In other words, it is a matter of when. OIS data suggests that markets are looking at a 45% chance of a rate hike in May next year. That is 12 months away. With inflation data still subdued at 1.9%y/y below the medium term 2-3% target and the wage price index for 1Q softening a little to 0.5%q/q from previous 0.6%, the current price pressure is hardly compelling for RBA to do anything at this point.

- That said, RBA has always been monitoring the exchange rate which has an impact on Australia's growth recovery. That is also the reason for its reluctance to signal any rate hike. We continue to maintain our view for RBA to raise rates in Aug. For much of the past few months, investors turned negative on AUD when its pace of hiring showed signs of peaking and decelerating. However, we remain rather optimistic. The latest labour report for Apr showed that full time employment growth seems to be stabilizing. While many focused on the jobless rate that ticked higher to 5.6% from previous 5.5%, we prefer to see this as encouraged worker effect. Even the May SoMP included a report on the labour force participation indicated that cyclical factors are likely to have contributed to the increase in labor force participation. The strong demand for labour and rising total hours worked encouraged some people to start searching for work. With hiring momentum still strong could allow room for RBA to raise cash target rate when inflation eventually picks pace.

- **Latest Fiscal and External Balance Outlook:** Budget deficit is forecast to be A$14.5bn for 2018-19. The government projects a surplus of A$2.2bn in 2019-20, in line with market expectation. The outstanding Australian government debt is projected to be at A$533bn by the end of June this year and at A$561bn at the end of Jun next year. Thus net debt is forecast to peak at 18.6% of GDP in 2017-18. In response, S&P held on to their negative watch on Australia, citing global trade tensions among risks for Australia.

- **Key domestic events and issues to watch:** May Commodity index on 1st Jun, retail sales on 4th; 1Q BoP Current account balance and RBA rate decision on 5th; 1Q GDP on 6th; trade on 7th; NAB business survey on 12th along with home loans; labour report on the 14th; RBA Jun Meeting Minutes on the 19th; May private sector credit on 29th;

- **Technical Outlook:** AUDUSD is capped by a strong resistance at around the 0.76-figure, last seen around 0.7575 after multiple attempts to break above it towards the end of May. Momentum is bullish on the daily chart. The close today is critical and we have US PCE core due for release tonight that could swing the pair in either way. A downside surprise could lift the pair. So far, this pair is poised to end the month with a mildly bullish candlestick for the month after three bearish candlesticks on the monthly chart. Weekly MACD is turning higher. A move back above the 0.7660 could boost AUD bulls and mark the shift back into the upward sloping trend channel, rendering moves in the past few weeks, a false break to the downside. If not, support is seen around 0.7480.

NZD: Consolidative Play Dominates

Forecast	2Q 2018	3Q 2018	4Q2018	1Q2019
NZDUSD	**0.7100** (--)	**0.7300** (--)	**0.7400** (--)	**0.7500** (--)

No Change to Previous Forecast

- **Motivation for the FX View:** Kiwi's weakness since mid-Apr somewhat stabilized in the month of May following a mild recovery in the NZGB-UST yield differentials. 10Y differentials narrowed from -22bps (15 May) to -9bps (29 May). This comes on the back of UST yields easing off its highs above 3.1% (last seen at 2.93%). We see consolidative play for NZD in the range of 0.6850 – 0.71 for the following few weeks as external factors such as Fed meeting in Jun (whether Fed will quicken its pace of monetary tightening resulting in higher USD funding cost), Italian political mess (spillover sentiment) and agri-commodity prices will play a dominant role in the volatility of the NZD. We maintain our NZD forecast over the next 4 quarters but there is risk that 4Q2018 – 1Q2019 forecast could be at risk of being lowered should inflation fails to pick up by then, resulting in deferred expectation for RBZN tightening.

- On US rates, recent development including Fed minutes (taken as dovish leaning) and price-related data suggests that current pace of Fed's monetary policy normalisation remains appropriate. Markets positioning for Fed to quicken its pace of normalisation may be disappointed and this should see UST yields ease off. Though a 25bps rate hike in Jun is expected for the Fed, the FoMC minutes did not show hints of Fed quickening their pace of tightening. Instead the mention of "a temporary period of inflation modestly above 2 percent would be consistent with the committee's symmetric inflation objective" suggests Fed's tolerance in the event of inflation overshooting its target. In addition the minutes also noted that the spread of the IOER over effective Fed fund rate had narrowed to only 5bps. A technical adjustment of the IOER is expected at the next meeting when the Fed is expected to tighten. Fed mentioned that this can be accomplished by implementing a 20bps increase in IOER at a time when the FoMC raises the target range by 25bps. This technical adjustment serves as a calibration exercise rather than an accommodation but does suggest that the Fed is taking steps to ensure that the effective fund is in the middle of the target range rather than skewed closer to the upper range. Slowing pace of US rate increase could help to stabilize the negative yield differentials between NZGB and UST. And this is supportive of the NZD.

- But gains are likely to be capped as little expectation for RBNZ rate hike this year vs. rising rates in US still suggests policy divergence between RBNZ and Fed could stay on. This would fuel the persistence of a negative carry environment (10Y NZ-UST yield differentials now at -9bps) and cap gains in the NZD. To add RBNZ MPS report noted that NZD funding markets have followed offshore markets in repricing higher. Domestic 90D bank bill rates are up about 15bps since Fed and this feeds into longer-term interest rates. The cost of swapping offshore funding into NZD has also increased since the beginning of the year. A persisting trend here could subject banks' NIM to compression and NZD could come under pressure. Tighter global financial conditions could affect global growth and this could reduce demand for NZ exports, and negatively impact consumption and business investment. This could lead to softer NZD as RBNZ could even cut rates to support activity (worst case scenario).

- Elsewhere given the ongoing stress (not blow-up) in EM markets (Turkey, Argentina, etc.) as well as political uncertainties in Italy and Spain, there may be a **"flight to quality" bonds to the antipodeans and to some extent, this is supportive of NZD in the interim**. Non-resident ownership of government bonds has seen its first rebound since the decline in Oct-2017 from 60.9% (to a low of 59% in Mar). As of May, non-resident holdings of NZ government bonds stood at 59.8%. Further flight to quality in times of global stresses (not blow-up of risks) could support NZD. However we caution that a blow-up of risks (i.e. EM sell-off deepens into crisis or Italy breakaway from Euro-membership, global recession, etc.) would be detrimental to global equity and this could weigh on NZD via the sentiment channel.

- **Growth and Inflation Outlook: NZ PMI report for Apr paint a case of divergence** with manufacturing growing at its fastest pace in 2 years (58.9 vs. 53.1 in Mar) while services sector expanded at a slower pace (55.9 vs. 58.6 in Mar) following a sharp surge in the prior month. PMI readings still indicate that activity is in expansionary territories. Growth for 2018 is likely to continue at current pace of around 3%, supported by net immigration, fiscal stimulus amid accommodative monetary policy. Though 4Q GDP slowed modestly to +0.6%, this was due to slower construction growth, weather-related weakness in dairy production. Services sector (makes up about 2/3 of GDP) is expected to remain one of the growth engines. 1Q GDP growth data is scheduled for release on 21 Jun.

- The last quarterly Monetary Policy Statement on May-2018 noted that NZ economy is projected to continue growing at an average of 3.1% over the next 3 years. Above-trend pace of growth is expected to be strong enough to generate an increase in capacity pressure and lift inflation around the midpoint of the RBNZ target range of 1 – 3% over the medium term.
- **1Q CPI slowed to 18-month low of 1.1% y/y** (vs. 1.6% in the last quarter). This comes close to the lower bound of RBNZ's inflation target range of 1 – 3%. Moderation in CPI was due to decline in education cost after government's decision to make the first year of tertiary education free while house construction prices rose at the smallest magnitude in 7 years. Breaking it down by tradables and non-tradable inflation, tradable prices fell 0.4% y/y due to airfares and appliances while non-tradable prices rose 2.3% y/y (due to rent and tobacco, the latter due to government imposition of tobacco taxes). The divergence between non-tradable and tradables suggests that early appreciation in NZD made imports cheaper.
- Our internal projection shows inflation trends lower towards RBNZ lower bound of its range at 1% in mid-2018 before rising towards RBNZ's median target of 2% in early 2019. We believe potential fiscal impulse and proposed minimum wage increase (minimum wage to be raised to NZ$20/hour by 2020; and to NZ$16.50 by Apr-2018) could support consumer spending and result in faster pick-up in inflation.
- In the last MPS on 10th May, RBNZ lowered inflation forecasts and predicted that inflation won't reach the 2% midpoint of its 1 – 3% target range until 4Q 2020 (vs. 3Q 2020 in prior projection). It also expects inflation to be lower than projected in the Fed MPS, reflecting a weaker outlook for tradables inflation.
- **Monetary Policy Forecast:** We expect RBNZ to keep OCR on hold at 1.75% at its upcoming meeting on 28 Jun amid softer inflation outlook, signs of moderation in global activity and ongoing stresses in Italy and EM assets. We were initially expecting RBNZ to possibly tighten rates as early as in 2H 2018 but given the recent comments from RBNZ Governor Orr that seem to suggest that easy monetary conditions could stay on for longer, we may defer our expectations to a later stage (some time in 2Q-3Q 2019). We still expect inflation to pick up, owing to fiscal impulse, minimum wage increase but this may come later.
- At the last MPC meeting (10 May), the OCR was kept on hold at 1.75% as widely expected. Accompanying statement was somewhat interpreted as dovish. It said that "OCR will remain at 1.75% for some time to come…the direction of our next move is equally balanced, up or down…only time and events will tell". Inflation below 2% target was being attributed in part to recent low food and import price inflation as well as subdued wage pressures. RBNZ also pushed back

its forecast for inflation to meet target in 4Q 2020, from 3Q 2020 prior. RBNZ's Orr also said that move lower in NZD after Thu's MPS is "a good thing". We think this could be taken as a passive aggressive hint that a softer Kiwi may be in Orr's preference. In his interview he emphasized that RBNZ wants core inflation to pick up towards 2% before tightening. He also made reference to the yield curve – that it has flattened and most economists now forecast rates won't rise until late next year – as "some of the message has got through". Little expectation for rate hike this year vs. rising rates in US suggests policy divergence between RBNZ and Fed could stay on for longer. This would fuel the persistence of a negative carry environment (10Y NZ-UST yield differentials now at -8bps) and may weigh on Kiwi for longer than expected.

- **Latest Fiscal and External Balance Outlook:** NZ government's operating surplus continues to surprise to the upside on higher than expected tax revenue. Operating Surplus before gains and losses (OBEGAL) was a surplus of $3.3bn in the 9 months ended Mar. Finance Minister Robertson forecasted a NZ$3bn budget surplus this year and possibly rising to NZ$7bn in 2020.

- 4Q current account deficit widened to $2bn in 4Q 2017 as the $407m increase in the deficit was driven mainly by NZ importing aircraft and other transport equipment and crude oil. The services surplus at +1.2bn remains steady from 3Q levels.

- **Key domestic events and issues to watch:** 1Q terms of trade (I Jun); 1Q manufacturing activity (11 Jun); food prices (13 Jun); May Mfg PMI (15 Jun); 1Q current account (20 Jun); `Q GDP (21 Jun); May trade (27 Jun); RBNZ meeting (28 Jun). GDT trade auctions take place on 5 and 19 Jun.

- **Technical Outlook:** Kiwi's decline since mid-Apr slowed in May and an interim base may have been formed around 0.6850 – 0.6870 levels. Bullish momentum on daily chart remains intact while weekly chart shows a potential bullish divergence in the making. Sustained rebound above 0.6980 (23.6% fibo retracement from Apr high to May low) puts next resistance at 0.7060 (38.2% fibo) and 0.7120 (50% fibo). Area of support at 0.6850 – 0.6870. Bias for upside play.

JPY: Risk-Off Proxy Plays Re-Emerge

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDJPY	108.50 (109.50)	106.00 (107.00)	104.00 (105.00)	104.00 (105.00)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** Our caution last month that the downmove in the JPY is likely to be temporary materialised as yield differentials between UST and JGB narrowed and safe-haven demand re-emerged. All these have allowed the JPY to go from being among the worst performing currencies in the G10 to being the best performing one as at 29 May. The JPY has gained 0.4% against the USD in May so far, reversing earlier losses. The risk is that the recent risk-off plays could result in some overshoot in the JPY for the time being, but expect some reversal in the JPY ahead as calm is somewhat restored in the markets.

- The JPY is currently trading below the 109-levels at the point of writing as risk proxy FX plays remained in focus. In the near term, safe-haven plays could dominate and keep the JPY supported. The ongoing political crises in Europe, currently centred on the Italian saga, have extended global risk aversion and sparked demand for safe-haven assets including the JPY. In addition, we could see further bouts of risk aversion as uncertainty continues to surround emerging market risks emanating from Turkey and Venezuela, the US/North Korea summit and trade negotiations between US and its trading partners, especially China. Thus, risk aversion plays could work in tandem with narrow yield differentials to keep the JPY supported in Jun. Given this combination of factors, we believe that the JPY could be supported around current levels at 108.50 by end-2Q vs. 109.50 previously.

- For the medium term, our broader thematic for a broad USD downtrend to persist in 2018 has not changed. We expect the current episode of USD strength to be temporary as the current pace of Fed rate hike remains appropriate given development in US price-related data, and that monetary policy normalisation in other major economies could take place at some point given higher energy/commodity prices and tightness in labour markets. Still, intermittent bouts of USD strength cannot be ruled out. Bouts of USD strength should weigh on the JPY and cap upside in the JPY.

- At the same time, a more gradual rise in UST yields can be expected ahead. The recent FOMC minutes that pitched a more gradual approach to rising rates weighed on UST yields and the USD. As UST rallied, yields have slipped below the 3.0% levels. Spreads between 10Y UST and JGB yields that had one point reached a 2018 high of 311bp (on 17 May) has now narrowed slightly to around 290bp.

Narrowing yield differentials between 10Y UST and JGB could persist into Jun, which should be supportive of the JPY..

- Market expectations for further JPY strength appear to have waned. Recent CFTC data showed investors betting against JPY strength due to widening yield differentials between UST and JGB. Net long-JPY positions have declined with investors still making long-JPY bets with 73836 contracts purchased in the week of 22 May but even larger bets of 76603 contracts for JPY weakness were made. But the recent dip in UST yields and the strengthening in the JPY in the aftermath of the FOMC minutes and re-emergence of safe-haven plays could see an increase in net JPY-long positioning, supportive of the JPY.

- A risk to our forecast is the simmering domestic political risk surrounding PM Abe that has rocked support for his government. Recent polls by Nikkei and Mainichi newspapers showed that support for his cabinet has hovered round 42% and 31% respectively, weighed by the scandals that involved PM Abe and his friends. Further slippages in support could embolden a challenge to PM Abe's leadership of the ruling party presidency in Sep. A loss could see a pullback in current easing policy and slow institutional and economic reforms even further. Domestic political risk is likely to put even more upside pressure on the JPY.

- We do not expect significant weakness in the JPY ahead. <u>June tends to be a seasonally strong month for the JPY unlike in May which is typically a JPY-negative month.</u> At the same time, we retain our view that the current episode of USD strength is temporary and that the Fed is likely to proceed gradually with its pace of normalisation. But given recent market developments and potential for UST-JGB yield differentials to narrow, we expect upside pressure on the JPY to intensify slightly in 2Q and beyond and tweak our USDJPY forecast accordingly. We now expect the USDJPY to hover around 108.50 (from 109.50 previously) by end-2Q 2018 and continue to trend lower to end-2018 at 104 (vs. 105 previously).

- **Growth and Inflation Outlook:** The Japanese economy declined by 0.2% (4Q: +0.4%) q/q or -0.6% (4Q: +0.6%) annualised in 1Q 2018. This marked the end of the economy's eight quarter expansion streak. The contraction in GDP can be attributed to sluggish private consumption (flat growth in 1Q vs. 4Q's +0.2%), the continued slippage in housing investment (-2.1% vs. 4Q's -2.7%) and dip in business spending (-0.1% vs. 4Q's +0.6%). It also did not help that exports slowed to +0.6% compared to 2.2% in 4Q. This correction though is unlikely to persist. This is because private consumption could pick up as the sluggish print in 1Q was due to bad weather that kept consumers at home. At the same time, export growth remains healthy, expanding by 7.8% y/y in Apr from 2.1% and 1.8% in Mar and Feb respectively, helped by softer JPY. More importantly, support from the government's FY2017 supplementary spending package of around JPY2tn as well as preparations in the run-up to the 2020 Olympics in Tokyo should bolster economic growth for the whole of 2018. Broadly though, the economic outlook in 2018 remains mixed with the economy unlikely to outperform in the quarters ahead. The BOJ expects the economy to expand by 1.6% and 0.8% in FY2018 and FY2019 respectively.

- Hopes for signs of a pick-up in inflationary pressures in Apr after the key gauges of inflation slowed in Mar did not materialised. Headline and core inflation both slowed to 0.6% and 0.7% y/y in Apr (Mar: +1.1% & 0.8%) respectively, while and core-core inflation (headline less fresh food & energy) moderated to 0.4% in Apr from 0.5% in Mar. The moderation in inflation makes it even more challenging for the BOJ to achieve its 2% inflation target. Still, there are hopes that inflation could pick-up ahead. Crude oil prices remain on the rise, while weakness in the JPY could lift import prices and these should put upside pressure on consumer prices. In its monetary policy statement in Apr, the BOJ removed the deadline for achieving the inflation target but the governor remains optimistic about hitting 2% inflation rate around fiscal 2019. The BOJ expects core inflation to come in at 1.3% in 2018 and at 1.8% (excluding the effects of the consumption tax hike) in FY2019 and FY2020.

- **Monetary Policy Forecast:** There was no policy meeting in May. At its last policy meeting on 26-27 Apr, the BOJ retained its ultra-loose monetary policy stance and left its balance (short-term) rate and its 10Y JGB yield target unchanged at -0.1% and around 0% respectively. The pace of asset purchase of JPY80tn annually was kept in place even though this measure is no longer central to its "QQE with Yield Curve Control" policy regime.

- Despite BOJ Governor Kuroda's mantra that the BOJ will continue with persistent monetary easing until the 2% inflation target is achieved, market continues to speculate about an exit strategy. Kuroda said that the BOJ would start communicating about exit when inflation improves and the economic environment is conducive to do so. But until the 2% is achieved, the BOJ will not embark on any exit strategy. Similarly, he said that not setting a target for the average maturity of BOJ bond purchases did not suggest that the BOJ was preparing for an exit. Nevertheless, we believe that these comments will not stop market speculation about an exit strategy. Such speculation could curb attempts by the JPY-bears to push the JPY lower beyond the 110-levels.

- **Latest Fiscal and External Balance Outlook:** Proposals by both the government and ruling party called for the time frame to achieve a balanced budget be delayed by five years to 2025. Should the government follow through with these proposals, this leaves room for PM Abe to employ fiscal tools to provide relief to Japanese consumers from next year's sales tax hike. At the same time, plans are afoot to temper the impact of sales the tax hike on consumption, including tax breaks for home purchases. In addition, the cap on annual increases in social spending (currently set at JPY500bn) is likely to be removed. These changes make fixing the budget imbalances even more difficult. Still, under the planned fiscal guidelines, the government will set three targets with the deadline of fiscal 2021, namely cutting the ratio of debt to GDP to around 180%; budget deficit to 1.5% of GDP; and the ratio of fiscal deficit to GDP to 3% or lower.

- The current account (CA) widened to JPY3.12tn in Mar from JPY2.08tn in Feb due to an improvement in goods and services surplus of JPY1.19tn (vs. Feb's JPY0.19tn surplus) and primary income surplus of

JPY2.11tn (vs. JPY1.95tn surplus in Feb). The financial account surplus ballooned to JPY4.61tn in Mar from JPY1.54tn in Feb, lifted by a rebound in the portfolio investment inflows of JP4.90tn vs. -JPY1.54tn in Feb that more than mitigated decline in “other investment” of –JPY0.91tn (vs. +JPY2.29tn in Feb). Consequently, the overall balance of payments (BoP) surplus jumped to JPY9.23tn in Mar from JPY3.08tn in Feb.

- **Key domestic events and issues to watch:** Final GDP for 1Q18 GDP will be released on 8 Jun. Also eyed will be BOJ policy meeting on 15 Jun. Also on tap is BOJ minutes of 26-27 Apr policy meeting and BOJ summary of opinions of 14-15 Jun meeting on 25 Jun. BOJ Governor Kuroda speaks at National Credit Union’s meeting on 20 Jun. JGB auctions in Jun: 10-year (6 Jun), 30-year (19 Jun), 5-year (21 Jun), 1-year (19 Jun) and 20-year (26 Jun).

- **Technical Outlook:** USDJPY traded a high of 111.40 (21 May) before turning lower. The move higher was in line with our call in the last FX Monthly which we called for an extended move towards 111.30. Pair has since eased. Last seen at 108.70 levels. Daily momentum turned bearish but stochastics is heading into near-oversold conditions. Support at 108 levels (50% fibo retracement of Mar low to May high) before 107.20 (61.8% fibo). Resistance at 108.80 (38.2% fibo) before 109.80 (23.6% fibo).

RMB: More Weakness against the Basket

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDCNY	6.40 (6.20)	6.35 (6.20)	6.30 (6.10)	6.25 (5.90)
USDCNH	6.41 (6.20)	6.35 (6.20)	6.30 (6.10)	6.25 (5.90)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** May was mainly characterized by bond defaults, US-China Trade Truce and a record high in the CFETS RMB Index. After two rounds of negotiations held within May, the US and China agreed not to impose additional tariffs. China has agreed to buy more imports from the US at the end of round 2 of negotiations that ended on 19 May. Next meeting is supposed to be in early June with US Commerce Secretary Wilbur Ross scheduled to visit Beijing for further negotiations. Recently, China announced a cut in import tariffs on car and looking forward, we can expect that the US will pay close attention on the trade balance data with China. Just ahead of the meeting in Beijing, the White House announced that a final list of targeted imports will be released by 15 Jun and the tariffs will be imposed "shortly thereafter" (Bloomberg). It was also reported that the US Commerce Secretary is urging for long-term import contracts with China (AFR). This could spur fresh speculation that China might deploy yuan as a tool in the trade war and boosted upsides in the USDCNH.

- The rise in the RMB CFETS index for most of the past few weeks is an erosion of RMB competiveness vs its largest trading partners and we think it could head lower from here as the USD and UST rates reverse lower. Fundamentally, China may not desire a less competitive RMB that could risk exacerbating its external balance deterioration should China decide to boost its demand for US goods. However, RMB is also unlikely to see much weakness when domestic environment is peppered by news of corporate bond default. Historically, RMB tends to be stable (vs. the USD) in times of credit pressure at home with the exception of strong USD episodes. Taking into consideration the run-up of USDCNY recently and the current external and domestic environment, we see USDCNY heading towards 6.30 by end of the year.

- **Growth and inflation outlook**: PMI-mfg improved marginally to 51.1 from previous 51.0 with Markit reporting a slight improvement in operating conditions. New order growth decelerated with a fresh fall in new export. According to the official statistics, PMI-mfg also rose slightly to 50.2 from the previous 50.1. PMI-mfg for large enterprise fell to 52.0 from 52.4 while those of small and medium enterprises actually rose in expansionary region. Retail sales slowed to 9.4%y/y in Apr from previous 10.1%. The deceleration was noted in urban and rural retail sales. Rising costs of funds, bond defaults and negative wealth effect could affect consumption and growth. However, that did not show up in the imports number for Apr. In CNY term, imports growth accelerated to 11.6%y/y from previous 5.9% while exports growth swung into a growth of 3.7%y/y from a previous contraction of -9.8%. Trade balance came in roughly in line with consensus at a print of CNY182.8bn. Foreign reserves in Apr slipped to U$3.12trn from previous U$3.14trn.

- **Growth prospects** are not lifted by the industrial production number which quickened to 7.0%y/y from previous 6.0%. Industrial profitability for private companies seemed to be on the decline while that of the State owned enterprises remained in high double digits, at 30.3%y/y for Apr. This period of deleveraging and tightening credit conditions could continue to weigh on private enterprises. With a potential of erosion in its current account surplus, China may prefer a more competitive RMB to support its external demand as it presses on with its reforms in its financial sector.

- Recall that the economic target for 2018 was softened to "around 6.5%" and the omission of the phrase "higher if possible" underscored the emphasis on better quality growth as opposed to more growth. So thus far, 1Q data has met expectations. The 6.5% economic growth still allows the China economy to be on course to achieve its 2020 target of doubling national income of 2010.

- Apart from the softer growth target as indicated above, China had made good its word to use differentiated reserve and credit policies to guide investments into smaller companies, agricultural sectors and poverty-stricken areas for 2018 with the latest RRR cut that took effect on 25 Apr. China will also maintain a “reasonable” growth of M2, credit and social financing, also to ensure appropriate and stable liquidity. The share of direct (especially equity) financing will also be raised.

- CPI slowed to 1.8%y/y from previous 2.1% on the back of the deceleration in food costs. The meat and poultry component remains on the decline, registering a steeper of 8.8%y/y compared to the previous 6.1%. New home prices rose 0.57%m/m from previous 0.42%.

- **Monetary Policy Forecast:** Despite the RRR cut in Apr, there were plenty of defaults by corporate bond issuers reported, some of whom cited “tightened credit conditions” for the default. The average repo rate that is weighted according to the outstanding repo securities dropped significantly last month before heading higher more recently while that of the OMO rates actually stayed rather elevated. We note that historically, PBoC tends to ensure yuan stability in times of credit pressure. We observe that CNY stabilizes vs. the USD during those times. That said, there are exceptions. USDCNY could still head higher when 3y AA-treasury note spread widens in episodes of strong USD strength. Overall, the defaults send a message that the government will not bail out corporates as much as before in the hope that retail investors will be more discerning in the future and credit risk can be more accurately priced. CBIRC’s drive to crimp on shadow financing, the clampdown on the sale of structured deposits with embedded options that have no intrinsic value, the prohibition of financial institutions to guarantee AMP returns, are to reduce the shadow financing risks and to channel funds back to traditional bank deposits. However, as rates continue to rise to better reflect the credit risk premium, PBoC could provide some relief at some point in a form of another 100bps RRR cut soon. The RMB, on the other hand, is likely to be “basically stable” - see two-way moves against the USD. We might even see a reversion of RMB management back to the pre-CCAF days where RMB could weaken against the CFETS basket when USD and UST rates turn in order to gain competitiveness should there be a need to support its external demand as it increases its purchases of US goods.

- **Latest Fiscal and External Balance Outlook:** China had set out a target earlier this year, to reduce its budget deficit target from 3% of GDP to 2.6%, lower than speculated 2.9%. While we do think it signals less fiscal stimulus given the fact that growth is projected to be softer and budget deficit target is also lower, a senior official clarified that this does not suggest less government spending in 2018 or signal an intensified effort to reduce central government debt. It seems that there is a separate government-managed funds budget that financed via returns on investment projects that could see a CNY550bn addition of deficit. Bear In mind that fiscal deficit has always been above the target 3% since 2015, at 3.7% of GDP for 2017.

- Also of interest is that the purchase of foreign currency by banks on behalf of clients shot to a netCNY92.4bn. Net forward also rose significantly to CNY31.7bn. The rise in net forex surplus was due to a combination of a drop in the sales of FX and also a rise in the purchase of FX. This suggests that there could be a rise in the selling pressure on the RMB against the foreign currencies.

- **Key domestic events and issues to watch:** NBS PMI numbers for May due on 31st May, Caixin PMI is due on the 1st Jun. FX Reserves on the 7th; trade data on the 8th; inflation on the 9th; Money supply, new yuan loans, aggregate financing on 10-15th; surveyed jobless rate, activity data on the 14th; new home prices on the 15th; FX net settlement (clients) on the 19h; industrial profits on the 27th; Jun NBS PMI-mfg on the 30th.

- **Technical Outlook:** Monthly momentum indicators are bullish still as stochs are only beginning to turn from oversold conditions. This pair may still head higher towards 6.4760 (50-mma). MACD is very bullish on the weekly chart but stochs are already in overbought conditions. Whereas on the daily chart, there is a bearish divergence in the price action vs. the MACD forest which suggests that a retracement could be due soon. If the pair has truly peaked at 6.4320, support lies around 6.3860 which was a strong resistance level before it gave way and now has turned into a support. A break there opens the way towards the 6.3570. 200-dma is seen around 6.4620, rather close to the 6.4760 (50-mma). That could be a level to sell towards. Target at 6.33. Stoploss at 6.50.

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDKRW	1065 (1050)	1060 (1040)	1055 (--)	1050 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** For the next few weeks, we expect USDKRW to enter a period of choppy trade, possibly in the range of 1064 – 1092. External events should continue to play the dominant role in driving the direction of KRW. Key factors or event risks to watch out including the direction of UST yield and USD, EM sell-off (if it continues or stabilizes), ongoing political mess in Italy (heightened uncertainty could weigh risk sentiment and the EUR), Fed meeting on 14th Jun (if Fed quickens its pace of tightening) and North Korea-US Summit in Singapore on 12th Jun (which can be delayed):

  – Slowing pace of UST yield increase and softer USD strength could take the pressure off the EM sell-off and that could help via sentiment channel and would be supportive of KRW. To be sure, Korea enjoys a current account surplus of +5% of GDP while the current EM sell-off episode punishes currencies of countries such as Turkey, Argentina whose current account are in deep deficit of around -5% of GDP. But we caution that the risk of an extended EM sell-off could spill over to other risk assets including regional equities and this could still weigh on KRW;

- Fed meeting on 14th Jun will also be closely scrutinized. In particular if the dots plot will shift to include a total of 4 rate hikes this year (vs. previous guidance of 3 hikes). Press conference will be watched to see if Fed or Chairman Powell hints at quickening pace of tightening. Absence of quicker pace and slowing US price-related data may help to put a temporary ceiling on UST yields and that could help to stabilize risk sentiment and is supportive of the KRW;
- Political situation in Italy remains fluid at point of writing. Lack of uncertainty on government formation and risk of re-election have widened BTP-Bund spreads to levels not seen since 2013. The sharp rise is Italian bond yields reflected investors' concerns with Italy's ability and willingness to honor debt obligations (sovereign debt stands at EUR2.3bn and is the largest in the Euro-area), especially in the event Italy exits EU (not base line scenario). Yields in other peripherals were also on the rise reflecting some concerns of contagion. Heightened uncertainty persisting in the Italy space could spill over to risk assets and weigh on the EUR. The repercussions would be negative for the KRW (correlation between KRW and EUR strengthened YTD with coefficient at +0.5). While the situation in Italy warrants caution, we do not expect an escalation into a full blown crisis in Italy (i.e. not expecting Italy to exit). Eventual clarity on the political situation should see concerns receding and that should take the pressure off KRW;
- Though a date and venue have been set for the Summit, we think there is still risk that the Summit maybe cancelled or postponed. And this could prove to weigh on KRW. For now, meetings are currently taking place concerning the Summit with Kim Young Chol (Vice Chairman of North Korea) in NY (30 May). In the event of a successful Summit, we believe local equities and KRW does have further upside to run. In the 2007 episode when North Korea agreed to close its main nuclear facility in Feb 2007, KOSPI rose by more than 30% from Feb/Mar to Jun while KRW gained more than 3% vs. USD in the same period. We acknowledge there may however be other market factors that took place at the same period that may have partially contributed to this. But for reference over the same period, MSCI World equities rose by about 30% while DXY fell about 2.3% (note that this is less than the decline in USDKRW). We are not entirely committed to say the Summit will be successful (i.e. complete denuclearization in just one meeting), but we believe there shouldn't be a case of deterioration in relations nor a resumption of threats. We believe the Summit could form the building blocks and result in some roadmap or future plan for North Korea to denuclearize in phases in return for security and other benefits (such as ascension/ as observers into WTO at a later stage, etc.).

- Taking stock of our call in the last issue of FX Monthly for USDKRW to test higher towards 1080-90 levels materialized. High was seen at 1086 (21 May). This can be attributed to rising UST yields, EM sell-off in Turkey, Argentina spilling over to risk sentiment and heightened political crisis in Italy.

- We retain our call for KRW strength to return on the back of (1) synchronised global economic recovery to bode well for Korean exports, benefitting trade-dependent currencies such as KRW; (2) signs of pick up in inflationary pressures leading to room for BoK to tighten monetary policy in 3Q; (3) hopes of easing geopolitical tensions. However given recent development (higher UST yields, EM sell-off and Italian political uncertainties), we calibrated USDKRW forecast slightly higher but maintained our forecast lower than consensus to reflect our positivity on the currency.

- **Growth and Inflation Outlook: For 2018, BoK still expects the economy to grow by 3%**, subject to global demand for memory chips and other manufactured goods. President Moon's proposed supplementary budget and wider budget deficit, to focus on job creation could further support growth, if it passes. Minimum wage increase (by about 16%) should also enlarge household wallet size and support private consumption. South Korea's economy expanded 2.8% y/y in 1Q (unchanged from 4Q). On a sequential basis, 1Q GDP rose +1.1% vs. -0.2% in 4Q, bolstered by exports recovery (rise in shipment of memory chips), corporate investment and government spending (due to policy change that increased the government's support for public health insurance). 1Q final GDP is scheduled for release on 1 Jun.

- **Inflation accelerated to 1.6% y/y in Apr (vs. 1.3% in Mar), owing to a rise in prices of agricultural goods and services.** Core CPI continue to rise modestly, for the 4th consecutive month in a row, to 1.4% (vs. 1.3% in Mar). BoK projects CPI to pick up in 2H 2018, after remaining in the mid-1% range. For 2018, CPI is expected to be slightly below the level projected in Jan at 1.7%. Core inflation is still expected to rise gradually.

- **Monetary Policy Forecast**: There is no MPC meeting in Jun. The next one is scheduled on 12th Jul and we retain our view for BoK to keep policy rate on hold at 1.5%. Though inflation is showing signs of picking up, the level remains below BoK's target of 2%. We see room for BoK to keep monetary policy accommodative for the time being but expect a 25bps hike this year if demand-induced price pressures picks up pace amid reacceleration in growth momentum. Minimum wage will increase by 16% this year, its largest magnitude of increase since 2001. Wage pass-through may have positive impact on consumption spending, growth and lead to inflationary pressures. The window of hike may shift from 3Q to 4Q 2018. BoK is expected to monitor if inflationary pressures from the demand side picks up and if higher oil prices over the past month translates into higher CPI prices ahead.

- At the last BoK meeting on 24 May, MPC kept policy rate on hold at 1.5% (unanimous decision), as widely expected. Accompanying statement noted that CPI will remain in the mid-1% range for some time this year and will gradually approach target in 2H; noted that solid trend of economic growth has continued; investment will slow but trend of steady increase in consumption will continue. BoK Governor Lee opined that EM rout does not seem contagious for now and do not see the possibility of stagflation in South Korea.

- **Latest Fiscal and External Balance Outlook:** Current account surplus narrowed sharply to $5.18bn in Mar from $5.72bn in Mar last year. This is due to a rise in dividend payouts to foreign investors (seasonality trends suggest dividend payouts are typically high in Mar and Apr). Elsewhere on the positive side, trade balance improved from $5.93bn in Feb to $9.88bn in Mar while deficit in travels balance (outbound travel rose 16% vs. inbound travel 11%) narrowed to $2.25bn in Mar (vs. $2.66bn in Feb). This marked the 73rd consecutive month of current account surplus which started in Mar-2012.

- President Moon has planned to redistribute income from companies and wealthy to working class by raising taxes on large corporate (25%, up from 22% for companies earning profits of KRW300bn or more) to finance assistance for SMEs. Income tax of individuals earning KRW500m or more will be increased to 42% from 40%. To recap his campaign promises the creation of 810,000 public sector jobs.

- **Key domestic events and issues to watch:** S. Korea releases 1Q final GDP, May CPI, exports, PMI Mfg (1 Jun); Apr current account balance (5 Jun); May unemployment rate (15 Jun); May export/import price (18 Jun): May PPI (21 Jun); Business survey for Mfg and Non-Mfg, May IP (29 Jun).

- **Technical Outlook:** USDKRW traded a touch firmer for the month of May. Last seen at 1077 levels. Bullish momentum on weekly chart remains intact while bullish trend channel formed since Apr-2018 remains intact. Consolidative price action within the trend channel range of 1070 – 1090 is likely but we are biased for a potential break of the channel to the downside. A successful outcome at the NK-US Summit on 12th Jun in Singapore should support sentiment and KRW. A break out of 1070 could see the pair test 1064. Key area of support at 1050-55 levels should still hold in the interim.

SGD: Mild Weakness To Persist For A While Longer

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDSGD	1.3300 (1.3000)	1.3100 (1.2800)	1.3000 (1.2700)	1.2900 (1.2600)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The SGD has been in a holding pattern in May after slipping lower from the last week of Apr. The SGD hit a 2018 low of 1.3490 (on 10 May) amid an USD resurgence but further downside did not materialize. Instead, the SGD has been hovering mostly within the 1.3360-1.3490 range vs. the USD since. Price action suggests that the SGD is awaiting directional clarity for its next move.

- Global risk aversion, due to emerging market risks led by Turkey and Venezuela; geopolitical risks over North Korea; political uncertainty in Italy and possibly in Spain; and escalating trade tensions between China and the US have so far capped upside in the SGD. On the flip side, the recent pullback for of a more aggressive Fed has led to some unwinding of USD longs vs. short-SGD positions, which is supportive of the SGD and limiting its downside.

- This combination of factors has allowed the SGD to perform better than most of its peers in ASEAN (with the exception of Indonesia) even as it weakens against the USD. Month-to-date in May, the SGD has dipped by 0.9% against the USD but which was still a better outcome as compared to the MYR, PHP and THB. Consequently, we do not expect the SGD to climb higher towards the 1.30-levels in 2Q now. Instead, we expect the SGD to slip lower towards the 1.33-levels against the USD by end-2Q.

- Despite our downward revision to the SGD vs. the USD in 2Q, we nevertheless remain sanguine on the SGD outlook ahead. Domestically, the synchronous global growth recovery that has lifted the trade-dependent economy to date should continue to be supportive of the economy. There could be some slight cooling off in growth in 2018 due to easing manufacturing and trade growth momentum but this slack could be taken up by a private investment recovery in the economy (as firms expand capacity to meet rising domestic and global demand). Still, there is a risk though that trade tensions could escalate into a trade war between the major trading nations that could have a negative consequence to global trade and growth, which would be SGD-negative. We will watch closely development on that front.

- The government's infrastructure programme, including developing Changi Airport Terminal 5 and redeveloping and rejuvenating the Jurong Lake District could continue to bolster growth even if the KL-Singapore High-speed rail is scrapped. Together, these should keep economic growth supported at 3.5% in 2018, which is at the top range of the government's 2.5-3.5% forecast range. Aside from the government's mildly expansionary fiscal policy, the country's triple-A status and persistent high balance of payments surpluses are also supportive of the SGD. These should provide investors with an incentive to not completely unwind their long-SGD positions.

- Externally, the broader thematic of a broad USD weakness remains. We continue to expect upside pressure on the SGD vs. the USD to come from this broad USD downtrend. We expect the current episode of USD strength to be temporary. Still, intermittent bouts of USD strength cannot be ruled out, which can weigh on the SGD. More importantly, Jun tends to be a seasonally strong month for the SGD vs. the USD, and we could see a strengthening of the SGD in Jun. **At the same time, persistent CNY strength via lower USDCNY daily fix in the aftermath of the removal of the counter-cyclical adjustment factor could provide an anchor for the SGD to appreciate given increasing positive sensitivity of USDCNY move on the USDSGD.**

- Given recent global risk aversion plays, we have changed our forecast to the USDSGD accordingly. We now expect the USDSGD to hover around the 1.33-levels by end-2Q. USD weakness in 2H should see the USDSGD headed lower to 1.31 by end-3Q before ending the year at 1.30.

- **Growth and Inflation Outlook:** The economy expanded by a better-than-expected 4.4% y/y in 1Q 2018 compared to the preliminary estimates of 4.3%. Lifting growth higher in the quarter was the services sector, which accelerated at the fastest pace in three years by +4.1% in Apr (vs. preliminary estimates of 3.85 and 4Q's 3.5%). Services growth continued to be primarily driven by finance & insurance segment. Manufacturing was revised lower to +9.8% from 10.1% in the advanced estimates (4Q: +4.8%), bolstered by electronics mainly. Construction remained a drag on the economy, having contracted for sixth consecutive quarter. The sector declined by an even more moderate pace of -2.0% vs. advanced estimates of -4.4% (4Q: -5.0%). Reflecting the stronger contribution of services and the more modest slowdown in manufacturing, our economic team has upgraded its GDP forecast for 2018 to 3.5% from 3.1% previously. The government, meanwhile, has narrowed its GDP forecast to the upper range of 2.5-3.5% for 2018.

- Market were disappointed when headline inflation softened to only +0.1% in Apr (compared to Mar's +0.2%) vs expectations for 0.4%. The drag on inflation was attributable to the fall in private road transport cost (Apr: -0.8% vs. Mar: -0.6%) due to lower Certificate of Entitlement premiums as well as the dip in housing & utilities (Apr: -2.3% vs. Mar: -2.0%) due to more moderate increase cost of electricity & gas and housing maintenance & repairs. These helped to offset the steeper rise in petrol prices in the month. Core inflation (headline inflation less accommodation & private transport) moderated in Apr, coming in at +1.3% (vs. +1.5% in Mar) on account of a smaller increase in retail prices (up 0.9% vs. Mar's +1.3%) and gas and electricity cost (Apr: +3.7% vs. Mar: +6.2%).

- Our economic team expects core inflation to grind higher for the rest of 2018 on stronger wage growth and broadening economic growth. In addition, price pressures from Changi Airport fee increases (starting 1 Jul), higher water prices (starting 1 Jul) and rise in gas tariff for households (from 1 May to 31 Jul) lift inflationary pressures. The team also expects rising oil prices to pass-through into consumer prices gradually in 2H. Consequently, the team maintains its headline and core inflation forecast at 0.9% and 1.7% respectively for 2018. As for MAS, it expects core inflation to rise gradually for the rest of 2018 to average at the upper half of its 1-2% forecast range for 2018. Similarly, it expects headline inflation to come in at the upper half of its 0-1% forecast range for 2018.

- **Monetary Policy Forecast**: The MAS normalised monetary policy at its semi-annual policy meeting on 13 Apr after pursuing an accommodative policy the past two-and-a-half years. The MAS shifted to a 'slight appreciation bias' for the SGD NEER by increasing slightly the slope of the policy band. The level at which the band is centred and the width of the policy band was left unchanged. Underpinning this move was MAS expectations that core inflation will rise gradually on the back of improving labour market and on moderate rise in oil and food commodity prices amid the steady expansion path of the economy. The MAS does not reveal its key parameters of its monetary policy but we assume the slope of the SGD NEER policy band to be at the stronger end of the 0-1% range at 0.75% p.a. This should allow for a stronger SGD on a trade-weighted basis to mitigate the expected climb in core inflation in both 2018 and 2019. With inflation not expected to overshoot MAS inflation goals, we expect the MAS to maintain its current 'slight appreciation bias' at its next policy meeting in Oct.

- The USDSGD has been in a holding pattern after climbing higher from the last week of Apr. Since touching a 2018 high of 1.3490 (on 10 May), the pair has been hovering mostly within the 1.3360-1.3490 range and was last seen around 1.3424 levels at the point of writing. The firmer USDSGD and rising 10Y UST yield has lifted the 3-month SOR to a new 2018 high of 1.73% on 10 May – a level not seen since 13 Jan 2016. Meanwhile, 3-month SIBOR has climbed to a new 10-year high of 1.5113% on 11 May. Both the 3-month SOR and 3-month SIBOR has eased off from their highs as market re-price for a less aggressive Fed in 2018. Domestics rate though remain elevated on the withdrawal of monetary stimulus in the other advanced economies that had kept the global financial markets flushed with liquidity. We are now gradually seeing mortgage rates respond to the climb in domestic rates. Deposit rates (for 12-month fixed) though have been on the slow grind higher and remains at 0.34% since end-Jan 2018. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, remains limited for now, though the risk is rising.

- US rates are on the grind higher with the USD 3MLIBOR climbing to a new 2018 high not seen since 2008 at 2.37% on 4 May. There are now signs that liquidity is being drained from the system and this has resulted in the recent moves higher in domestic rates vis-à-vis the USD 3MLIBOR. We continue to expect the 3MSIBOR and 3MSOR to edge higher to 2.00% and 1.78% respectively by end 2Q 2018. For end-2018, we continue to expect the rates to accelerate to 2.19% and 1.97% respectively.

- **Latest Fiscal and External Balance Outlook:** The government budget plans for FY2018 revealed a budget surplus of SGD9.6bn (2.1% of GDP) in FY2017. This not only far exceeded the projected surplus of SGD1.9bn but also the highest budget surplus as a % of GDP since FY2007 where growth was strong. For FY2018, the government is conservatively projecting a negligible budget deficit of 0.1% of GDP for FY2018. Other key highlights of the budget include a one-off "hongbao' of up to SGD300 to each adult Singaporean (costing SGD700mn) will be distributed even though this is not an election year. The much talked-about GST hike did not come to fruition. Instead, the government deferred any GST hike until 2021-25, though it is likely to take place "earlier rather than later". The GST hike will be implemented progressively, with offsets from a permanent GST voucher and offset package to cushion the impact on lower and middle-income households. A 2%-point hike is expected to generate revenue of nearly 0.7% of GDP per year to fund healthcare and infrastructure spending. Another highlight was a hike in the top marginal stamp duty to 4% (from 3%) for residential property valued in excess of SGD1mn effective 20 Feb. This also applies to en bloc property deals. The government also intends to implement an imported services tax in 2020 and a carbon tax in 2019. Imported services affected included apps, software, online subscription fees, marketing, IT and management services. The carbon tax of SGD5/tonne of greenhouse gas emission will be implemented in 2019 - 23 to cut carbon footprint. Petrol, diesel & compressed natural gas are exempted as they already incur excise tax duties.

- The current account (CA) surplus started 2018 on a positive note. The CA surplus widened to SGD20.5bn in 1Q 2018 from SGD17.8bn in 4Q 2017. As a percentage of GDP, the CA surplus rose to 17.9% in 1Q vs. 15.1% in 4Q. The larger CA surplus was due to an increase in the goods and services surplus of SGD28.8bn (from 4Q's SGD27.6bn) and the smaller outflow from both the primary (1Q: -SGD5.1bn vs. 4Q: SGD5.4bn) and secondary (1Q: -SGD2.0bn vs. 4Q: SGD2.1bn) accounts. The financial and capital deficit widened to SGD14.2bn in 1Q compared to SGD10.8bn in 4Q, underpinned by larger outflows from the "other investment" segment of SGD23.9bn. Consequently, the overall balance of payments (BoP) surplus widened to SGD6.8bn in 1Q from SGD5.9bn in 4Q.

- **Key domestic events and issues to watch:** CPI for May (on 25 Jun) will be eyed for oil-related inflationary pressures, while PMI (4 Jun) and industrial production (26 Jun) will be watched for signs of any moderation in the synchronised global recovery.

- **Technical Outlook:** Our call for USDSGD to test higher towards 1.3390 was met. Pair traded a high of 1.3484 (29 May) before easing off. Last seen at 1.3370 levels. Daily momentum turned bearish while stochastics on the weekly and daily chart shows signs of turning lower from overbought conditions. A turn lower towards 1.3330 (38.2% fibo retracement of Apr low to May high) and 1.3285 (50% fibo) should not be ruled out. Interim resistance seen at 1.3490. Biased for downside play.

MYR: Solid fundamentals Amid Cautious Transition Period

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDMYR	3.9500 (3.8500)	3.8500 (3.7000)	3.8000 (3.6500)	3.8000 (3.6500)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** In line with most other regional currencies, the MYR weakened against the USD by around 1.8% in the month of May. It reached a high of 3.9948 on 30 May 2018. In the run up to the general elections on 9 May, the MYR has remained largely cautious in 2018 – ranging tightly around the 3.85-3.95 range.

- Given latest external developments (EM volatility and Italian political uncertainty) and revisions to our G7 forecasts leading to adjustments to our dollar levels, we revise higher our USDMYR forecasts for this year. Current level of Ringgit remains fundamentally undervalued relative to our updated fair value estimates of 3.56 for USDMYR and we expect this misalignment to correct further in the longer term. MYR fundamentals remain well anchored by sustained current account surplus, rising FX reserves to retained imports & short-term debt, sustained growth pick-up backed by consumption, investment and exports as well as higher oil prices. We maintain our lower USDMYR forecast trajectory beyond 2018 on efforts taken by the new government to improve governance, transparency and accountability. However, we acknowledge there could still be some uncertainty over the next few years as the new government navigates the new political environment and foreign investors still remain somewhat cautious for now. As such taking into consideration both domestic and external factors, we now have a slower pace of MYR appreciation vis-à-vis the dollar, consistent with our USD weakness view in the medium term. On the domestic front in the short term, the earliest time for more policy clarity and more details is likely July, early Aug, so before this a weak MYR bias coupled with USD strength will likely persist, before some element of certainty comes from the Budget 2019 in Oct. Overall in the short term, domestic policy uncertainty risk may still somewhat weigh on the MYR despite solid fundamantals.

- We believe the 100-day promises made by PH in its manifesto will be a "scorecard" for investors to check if PH and its team of Eminent Persons fulfilled their objectives, in terms of execution and implementation. Swift execution of its objectives and clear communication to address government finances will demonstrate the new government's capability; dispel uncertainty associated with government policies and restore investors' confidence within the next 100 days. This could manifest into further gains for the Ringgit. Meantime we do not rule out bouts of volatility as investors await results. While sentiment may have stabilised for now and we continue to maintain a bullish bias on the Ringgit, FX is never one way and is also driven by externalities including global monetary policies, financing conditions, USD direction, pace of UST yield upmove, geopolitical events (such as tensions in middle east that may affect oil prices, US mid-term elections), ongoing trade tensions, etc..

- We reiterate our long-standing bias that the Ringgit remains fundamentally undervalued (by about 5%). Our fair value model which takes into account the relative differentials in interest rates, inflation, current account and a reflation proxy variable (defined as the change in the ratio of MSCI World index to JPM Global Aggregate Bond Index) estimates USDMYR at 3.70 levels. Based on BIS data, MYR REER is about 5-6% undervalued relative to its 10-year average. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals. We believe stability is gradually returning to Ringgit as political/ contingent liability risk subsides, fiscal consolidation gains traction (budget deficit expected to be cut further to -2.8% of GDP vs. 3% of GDP in 2017), oil prices continue to stabilize and uncertainty subsides.

- The key risks to our outlook are (1) sharp rise in UST yields due to more aggressive than expected Fed policy normalisation could lead to foreign outflows and weigh on Ringgit and (2) risk-off plays/ rise in vols (uncertainty) arising out of synchronous recovery stalling, swings in crude oil and/or palm oil prices to the downside may weigh on Ringgit; (3) As a trade dependent country, risks of trade war could weigh on the MYR as well as other currencies in ASEAN, (4) higher risk from EM volatility and eurozone risk escalation emanating from Italy, as investors re-allocate in the overall investment portfolio.

- External reserves fell marginally by -USD0.1b to USD109.4b as at 15 May 2018 from USD109.5b as at 30 Apr 2018 amid indication of net portfolio outflows before and after GE14, following the +USD6.3b surge between end-Feb 2018 and mid-Apr 2018. The latest tally is equivalent to 7.6 months of retained imports and 1.1 times of short-term external debt. Equity portfolio capital outflows pre- and post-GE14 Foreigners were net sellers of Malaysian equities so far in May 2018 (1-21 May) totaling –MYR3.8b after a net buy of +MYR1.5b in Apr 2018. Foreign investors reacted to the surprised outcome of Malaysia’s 14th General Election by selling a net –MYR2.6b worth of Malaysian equities in the post-GE14 period of 14-21 May 2018, adding to the pre-GE14 net selling of –MYR1.2b during 1-8 May 2018. External factors also contributed to the foreign net sell of equities amid weakening sentiment on Emerging Markets amid the apparent truism of “sell in May and go away”. Meanwhile, foreigners were net sellers in the Malaysian bond market totaling –MYR4.7b in Apr 2018 (Mar 2018: +MYR2.9b). Our fixed income research team does not expect significant outflows of foreign funds from Malaysian bonds post-GE14 amid a more “stable” composition of foreign bondholders with the bulk being longer term investors, namely indextracking global funds, central banks, sovereign wealth funds, pension funds and insurance companies. In addition, government bond that expired this month was MYR7.5b GII on 15 May 2018, where foreign holdings are much lower on average (6.5% share of total outstanding as at Apr 2018) vs MGS (44.3% share of total outstanding as at Apr 2018).

- Trade flows remain supportive of external reserves via the repatriation of net export earnings, taking cue from the trade surplus which jumped +76.8% YoY and +20.7% QoQ to +MYR33.4b in 1Q 2018. External reserves is therefore expected to continue on its general and gradual uptrend on sustained trade surplus amid the volatility in portfolio capital flows as we expect the trade surplus to widened to +MYR123.2b this year (2017: +MYR97.2b). Meanwhile, inward FDI momentum was sustained i.e. MYR13.8b (USD3.5b) in 1Q 2018 vs MYR11.3b (USD2.5b) in 1Q 2017 and more than one-third of the total MYR41b (USD9.5b) in 2017.

- We reiterate our **long-standing bias that the Ringgit remains fundamentally undervalued.** Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.70 levels. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We believe stability is gradually returning to Ringgit as political/ contingent liability risk subsides, fiscal consolidation gains traction, oil prices continue to stabilize and uncertainty subsides. Solid underlying fundamentals and policies, backed by domestic demand, re-calibrated supportive budget (on a lower oil price assumption suggests flexibility in the fiscal space), relative stability in oil prices though some downside pressure exists, relative attractive yields in the MGS, stabilizing FX reserves to retained imports & short-term debt, accommodative monetary conditions (to support businesses) remain intact and should provide an anchor for MYR stability once short-term noises subside. **We still believe USDMYR range of 3.80-3.90 is likely to remain relatively sustained for 1H 2018 before potentially moving to a 3.60-3.80 range in the second half of 2018, on the back also in part from USD dynamics.**

- **Growth and Inflation Outlook:** Available economic indicators in Apr 2018 are mixed as in pointing to slowing output but firmer demand, which implies the economy is going through “inventory correction”, consistent with the data showing four consecutive months of falling intermediate goods imports up to Mar 2018.

- On the supply side, manufacturing purchasing managers index (PMI), dropped for the third month in a row to 48.6 in Apr 2018 (Mar 2018: 49.5; 1Q 2017: 50.0), and fell -4.1% YoY (Mar 2018: 0.0% YoY; 1Q 2018: +1.6% YoY), signaling moderation in manufacturing sector growth. Crude palm oil output growth slumped to +0.7% YoY in Apr 2018 (Mar 2018: +7.5% YoY; 1Q 2018: +12.6% YoY) indicating deceleration in agriculture sector growth.

- On the demand side, motor vehicles sales – which we estimated to be around 9% of total private consumption expenditure - rebounded by +10.2% YoY last month (Mar 2018: -6.9% YoY) while its production picked up +11.5% YoY (Mar 2018: +2.3% YoY). Exports of palm oil – around 5% of total exports - remained robust in Apr 2018 at +20% YoY (Mar 2018: +23.7% YoY).

- We **maintain our 2018 real GDP growth forecast of +5.3% for now, but have adjusted the components of growth to take into account**

of 1Q 2018 GDP figures and the expected economic impact of PH Government's first 100-day promises in the election manifesto that have been announced so far. In particular, the change in GST rate to 0% from 6% effective 1 June 2018 as well as the de-facto return on fuel price subsidy should be positive for consumer spending which makes up 54% of GDP. However, reviews in Government spending and major infrastructure projects will adversely affect public consumption and investment growth that account for 38% of GDP. There will be further revision to our growth forecast as we get more details and clarity on PH Government's economic policies given other pending first 100-day measures such as the re-introduction of Sales and Services Taxes (SST), minimum wage hike and the outcome of the reviews in Government spending and mega projects.

- Both headline and core inflation rate remained sub-2% for the third straight month in Apr 2018 at +1.4% YoY (Mar 2018: +1.3% YoY) and +1.5% YoY (Mar 2018: +1.7% YoY) respectively. Lower our 2018 headline inflation rate forecast to a range of +1.5% to +2.0% from +2.3% previously (Jan-Apr 2018: +1.7% YoY; 2017: +3.7%). Overnight Policy Rate (OPR) to stay at 3.25% the rest of this year after the +25bps hike on 25 Jan 2018.

- We lowered our 2018 inflation rate forecast to a range of +1.5% to +2.0% from +2.3% previously primarily on account of the two key policy changes under the new Pakatan Harapan (PH) Government that are expected to keep a lid on inflation, as well as taking into account of the +1.7% inflation rate in Jan-Apr 2018 (2017: +3.7%). The two policy announcements that affect inflation rate are the cut in GST rate to 0% from 6% on all standard-rated goods and services effective 1 June 2018, and the de-facto return of fuel price subsidy as domestic fuel prices are maintained at current levels. Prices for RON97, RON95 and diesel have been unchanged at MYR2.47/litre, MYR2.20/litre and MYR2.18/litre respectively since it was set at these levels on 22 Mar 2018 under the weekly managed float system. This was despite the +15% rise in global crude oil (Brent) price since then until 22 May 2018.

- No change in OPR for the rest of 2018. Based on projection released in Mar 2018, BNM also expects inflation rate to moderate this year to between +2.0% to +3.0% (2017: +3.7%). With slowing of inflation rate so far this year and the downward revision in our full-year forecast noted above, we see no change in BNM's current Overnight Policy Rate (OPR) level of 3.25% for the rest of the year after the +25bps at its Monetary Policy Committee (MPC) meeting on 25 Jan 2018. To note, BNM kept the OPR unchanged for the second consecutive meeting this year on 10 May 2018, a day after GE14.

- **Monetary Policy Forecast:** After raising the Overnight Policy Rate (OPR) by +25bps to 3.25% at its Monetary Policy Committee (MPC) meeting on 25 Jan 2018, BNM kept the OPR unchanged for the second consecutive meeting this year. The decision is to ensure continued steady growth path amid prospect of lower inflation this year. With the general election over, we maintain our view of "One and Done" on OPR this year, unless there are upside surprises to real GDP growth and inflation rate.

- Despite the recent re-emergence of global financial market volatility and trade tension, BNM continue to maintain its upbeat assessment on global economic growth, in turn keeping its 2018 real GDP growth forecast of 5.5%-6.0% (upgraded from 5.0%-5.5% in Mar 2018) on the back of sustained external demand as well as continuity in domestic demand growth that is underpinned by private sector spending amid favourable income and labour market conditions, spending on new and ongoing infrastructure projects and sustained capital investment in the manufacturing and services sectors.

- BNM expect inflation rate to moderate this year (2018E Official: +2.0 to +3.0%; 2018E MKE: +2.3%; Jan-Mar 2018: +1.8% YoY; 2017: +3.7%) on smaller effect of global cost factors as the rise in crude oil price being balanced by Ringgit's appreciation which mitigate the adverse impact on import costs.

- **We maintain our view that OPR will stay at 3.25% for the rest of this year after the +25bps hike at the first MPC of this year in Jan 2018.** Furthermore, unless the US Fed turns very aggressive on its interest rate hikes vs the current guidance, there is currently "positive carry" in terms of the differences between Malaysia and US interest rates and between domestic interest rate and inflation rate which should not necessitate further interest rate hike this year. Malaysia is also ahead of the curve in normalizing its interest rate i.e. since 2011, as the current OPR is just 25bps short of the pre-GFC peak of 3.50%.

- **Latest Fiscal and External Balance Outlook:** While the planned removal of GST, reinstatement of fuel price subsidy and raising minimum wage were meant to alleviate living costs for the nation, the measures are expected to have repercussions on government finances. Most importantly, will these measures result in increased burden for the government in terms of borrowings and will the fiscal discipline or sovereign credit rating be compromised?

- Our Economists estimated that GST removal entails a revenue loss of MYR44bn (based on Budget 2018 projection). **Replacing GST with the previous Sales and Services Tax (SST) which last earned a full-year revenue of MYR17b in 2014, there is a prospective net tax revenue loss of MYR27b.** Malaysia's budget deficit to GDP ratio will arithmetically increase by as much as 1.9 percentage points, just on this basis alone, assuming no offsetting reduction in expenditures or revenues from oil or more efficient collection of taxes. However this is only a simplistic assumption for preliminary illustration. **Former BNM Governor Zeti (currently a member of the Eminent Persons) recently said that Malaysia can meet its revenue requirements after shelving the GST by prioritising its projects, increasing the efficiency of the public sector, avoiding wastages and exploring new sources of revenue.**

- Our Economists also noted that PH's Alternative Budget 2018 argues there is scope for operation expenditure rationalisation such as lowering the Prime Minister's Department budget to MYR8.4bn from MYR20.8bn.

- On oil prices, our Economists shared that every US$10/bbl increase in annual average crude oil prices will boost government revenues by MYR7-8bn via oil related revenues. Last year's average crude oil price averaged US$54/bbl, up from US$44/bbl in 2016. And YTD 2018, crude oil price averaged about US$69. Theoretically the US$15 increase in crude prices from 2017 works out to a potential increase in government revenues by MYR10.5bn – 12bn.
- Potentially higher government revenues from increase in oil prices could partially buffer against revenue losses from removal of GST and re-instatement of fuel subsidy.
- We had previously shared that brent could be poised for further upside, with next objective seen at $82 (61.8% fibo retracement of 2014 peak to 2016 trough). Support levels seen at $71.50, $61 levels. Upside risks to oil prices suggest room for positive surprise as government budget assumption (Budget 2018) for oil prices was conservative at $52/bbl.
- Current account surplus widened to +MYR15.0b or +4.4% of GDP in 1Q 2018 (4Q 2017: +MYR13.9b or +3.9% of GDP, revised from +MYR12.9b or +3.6% of GDP) on larger goods account surplus and smaller deficit in services account. Revised our 2018 current account surplus forecast to +MYR51b or 3.5% of GDP from +MYR43.0b or +3.0% of GDP previously (2017:+MYR40.3b or +3.0% of GDP).
- Financial account posted bigger surplus of +MYR15.2b in 1Q 2018 (4Q 2017: +MYR6.0b, revised from +MYR5.0b) on huge net inflow of direct investment which offset outflows in portfolio investment and other investments. Portfolio investments turned into net outflow (1Q 2018: - MYR2.6b; 4Q 2017: +MYR11.6b, revised from +MYR11.7b) while net outflow in other investments shrank (1Q 2018: -MYR6.4b; 4Q 2017: -MYR9.5b, revised from -MYR10.9b). Direct investment posted bigger net inflow (1Q 2018: +MYR10.7b; 4Q 2017: +MYR5.3b, revised from +MYR5.1b) as foreign direct investment (FDI) exceeded direct investment abroad (DIA). Sustained current account surplus
- No change in our view that the sustained growth momentum in the global economy this year (2018E; +3.8%; 2017: +3.8%) should be able to keep global trade growth to remain positive. Nevertheless, the high base effect is expected to keep Malaysia's external trade growth at single digit as gross exports and gross imports growth are expected to moderate in 2018 to +6.0% (vs +5.9% previously; 2017: +18.9%) and +3.5% (vs +5.8% previously 2017: +19.9%) respectively. Despite the single-digit exports and imports growth, trade surplus is projected to widen to +MYR123.3b this year (vs +MYR103.8b previously; 2017: +MYR97.3b). IN view of the robust 1Q 2018 current account surplus, **we raised our full-year 2018 current account surplus forecast to +MYR51b or 3.5% of GDP from +MYR43.0b or +3.0% of GDP previously (2017:+MYR40.3b or +3.0% of GDP).** Despite the promising view on global growth and global trade this year, we remain vigilant on downside risks to the forecasts. These include the larger than expected monetary policy normalization in the US; which could lead to volatile financial markets and capital flows that could weigh on growth momentum, as well as escalating geopolitical risks and

trade tension between the US and China. We estimated that a 1ppt drop in global economic and trade growth could pull down Malaysia's real GDP growth by as much as 0.7-0.8 ppt.

- **Key domestic events and issues to watch:** Trade data (4 May); FX reserves (7 & 22 May); Industrial Production (10 May); CPI (23 May), BNM Policy Meeting (10 May), GDP 1Q (17 May).
- **Technical Outlook:** USDMYR traded higher for the month of May. Pair was last seen at 3.9780 levels. Pair has broken out of the bullish trend channel formed since mid-Apr to the downside. Bullish momentum on daily chart is waning while stochastics shows signs of falling from overbought conditions. Technical suggests the risk of further pullback. Support at 3.9620 (23.6% fibo retracement of Apr low to May high) before 3.9410 (38.2% fibo). Resistance at 4 levels.

IDR: BI "Walks-The-Talk" To Credibility

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDIDR	13800 (--)	13600 (--)	13500 (--)	13400 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** The IDR had been the worst performing currency in ASEAN for the most part of May owing to global aversion to emerging market risk. Twin deficits in its current and fiscal accounts had marked Indonesia as vulnerable to any market reversal. In addition, the high foreign ownership of IndoGB was another indicator of Indonesia's larger exposure to the global markets. Foreign investors took flight and sold nearly USD1.16bn in debt up to 24 May. Consequently, the IDR fell by 1.6% against the USD since the start of May to 24 May. Since 24 Mar to date, the IDR has turned around and is the best performing currency in ASEAN, gaining 1.8% vs. the USD.
- The arrival of newly-minted governor Perry Warjiyo to BI was the game changer for the IDR to a certain extent. His firm commitment to use monetary policy to stem the sell-off in the IDR and bonds helped calm the markets. He pledged to be "more pre-emptive, front-loaded and ahead of the curve in terms of rate policy". More importantly, he put words into action, calling for an out-of-cycle policy meeting on 30 May to discuss the current economic situation. He then "walked-the-talk" when he led the BI to raise the benchmark 7-day reverse repo rate by 25bp to 4.75%. The new governor also announced that macroprudential measures would be revealed in due course (we believe could be as soon as the first week of Jun).
- While further adjustments in monetary policy will be data-dependent, the governor warned that the BI will continue to "calibrate

developments, domestic and global, to make use of available space for higher rates in a measured way". This suggests that while BI remains open to further rate hikes to stabilise the IDR, it is in no rush to do so but will act accordingly to market conditions. While our economic team does not expect further rate hikes this year, we cannot rule out such moves if global risks spike and destabilises the IDR. Not surprisingly, the action of BI to date has been IDR-positive and has allowed the IDR to fall back below the 14000-handle to hover below the 13990-levels at the point of writing.

- Note though that there are several risks to the IDR ahead. As mentioned earlier, the twin deficits remain a market concern as they expose the external and domestic vulnerabilities of the economy. Latest data showed that the current account deficit (CAD) stood at 2.15% in 1Q 2018, though this was an improvement over 4Q's 2.43%. However, the CAD is still elevated when compared to the narrower deficits during the 4Q 2016-3Q 2017 at -1.86 to -0.75%. The CAD Is expected to rise as a result of the government's infrastructure building programme as well as higher oil prices. FinMin Sri Mulyani expects the deficit to come in around 2.5% of GDP for the whole of 2018.

- As for the fiscal deficit, elevated oil prices have led to plans by President Jokowi to increase and double diesel subsidies to IDR1000/litre from IDR500/litre. This should blow out the IDR94.5tn allocated to energy subsidies for 2018 and widen the budget deficit. The government though intends to maintain its 2018 fiscal deficit target of 2.19% of GDP. Concerns about a wider fiscal deficit could weigh on the IDR and mitigate gains to the currency from BI's rate hikes.

- The sell-off in Indonesian equities and debt is not expected to continue unabated. The narrowing policy divergence between US and Indonesia could provide some relief from the recent debt sell-off by foreign investors, who had sold USD0.52bn in debt so far this year. The expectations of poor corporate earnings given lackluster private consumption and concerns of a slowdown in exports that has weighed on demand for equities by foreign investors could reverse. Year-to-date, they have sold USD2.89bn in equities. We expect renewed foreign confidence in Indonesia to stem foreign portfolio outflows to a certain extent and help support the IDR for the rest of the year.

- At the same time, relatively healthy economic growth of 5.1-5.5% in 2018 driven by the synchronous global recovery and government spending on infrastructure should also be supportive of the IDR. More importantly is the government's USD400bn infrastructure programme that should not only bolster near term growth but potential growth as well. Campaign spending ahead of legislative and Presidential elections on 17 Apr 2019 should also keep the growth momentum going. In addition, spending in preparation for the Asian games slated to take place 18 Aug-2 Sep should be supportive of growth ahead. The 15 reform/stimulus packages introduced so far should help to cut red tape and liberalize rules that have been a drag on the economy. In addition, expectations of broad USD downtrend should also be supportive of the IDR.

- Renewed confidence in BI credibility, together with ongoing intervention in both the FX and debt markets, is expected to stem IDR weakness for now. We expect these to put upside pressure to the IDR, though bouts of global risk aversion could slow the currency's move higher. Beyond 2H, the pick-up in economic momentum underpinned by the acceleration of the government's USD400bn infrastructure spending, and campaign spending ahead of legislative and Presidential elections scheduled on 17 Apr 2019 should bolster the IDR. In addition, spending in preparation of the Asian Games (18 Aug-2 Sep) should also boost growth momentum and hence keep the IDR supported. We maintain our forecast for the USDIDR to ease to 13800 by end-2Q 2018 from current levels and then to 13500 by year-end.

- **Growth and Inflation Outlook:** Against market expectations for growth of 5.19%, the economy rose by just 5.06% y/y in 1Q 2018. This disappointment was due to sluggish private consumption that rose by 4.95% y/y, little changed from 4Q's 4.97% and moderation in government spending of 2.73% vs. 3.81% in 4Q. The outlook for the economy in 1Q 2018 does not look that dreary. Motorcycle sales - a proxy for consumer spending - rebounded in 1Q, rising by 4.0% y/y vs. -2.2% in 4Q 2017. Despite the slower-than-expected growth in 1Q, our economic remains sanguine about growth prospects for the rest of the year. The team looks for government spending and supported external demand to boost growth ahead. Even the two rate hikes this year are unlikely to lower economic growth according to BI governor Warjiyo. We tend to agree as the growth momentum should be sustained beyond 1Q 2018 on the back of the President's USD400bn infrastructure programme push. In addition, accelerated infrastructure spending ahead of legislative and Presidential elections in Apr 2019 should keep the growth momentum going. Spending in preparation for the Asian games slated to take place 18 Aug-2 Sep is also supportive of growth ahead. Still, lackluster private spending could be a drag on growth and cap GDP growth, though macroprudential measures could mitigate some of this risk. For 2018, BI is projecting GDP growth of 5.1-5.5% in 2018, while our economic team is still penciling growth at 5.30% for 2018.

- Headline inflation accelerated for the second consecutive month, rising by 3.41% y/y in Apr compared to 3.40% in Mar. Driving inflation higher was food prices (up 4.19% vs. Mar: 4.06%), and healthcare cost (+3.05% vs. Mar: 2.91%). Mitigating some of this price increases was more moderate increase in housing & utilities cost (+2.81% vs. Mar: 3.45%) and transport cost (of +1.75% vs. Mar: 1.83%). Core inflation inched slightly higher, rising by 2.69% in Apr compared to 2.67% y/y in Mar. There could be a temporary spike in inflation in Jun due to the Ramadan celebration. Ongoing efforts by the government to improve food supply and control prices of key commodities via stricter monitoring should help keep food inflation down to a certain extent. In addition, the government is mulling plans to regulate the price of non-subsidised fuel to help stem inflationary prices amid rising global oil price and lift the subsidies for diesel to USD1000/litre from USD500/litre. IDR weakness is likely to be another source of inflationary pressure, driving up imported good prices, including oil. Our economic team maintains its headline and core inflation forecast at 3.52% and 2.82% respectively for 2018 as compared to BI's target range of 2.5-4.5%.

- **Monetary Policy Forecast:** The BI adjusted its benchmark policy rate for the second time in two weeks, lifting the 7-day reverse repo rate by 25bp to 4.75% on 30 May. The deposit and lending facility rates were also raised by 25bp accordingly to 4.00% and 5.50% respectively. The interest rate corridor was maintained at 75bp on either side of the policy rate. According to the governor, this was a pre-emptive move ahead of the expected rate hike by the Fed in Jun. He committed the BI to use monetary policy to stem the sell-off in the IDR and bonds helped calm the markets, promising to be "more pre-emptive, front-loaded and ahead of the curve in terms of rate policy". No macroprudential measures were announced in tandem with the policy rate hike. Instead, the governor said that macroprudential measures were being prepared and will be in place in due course (we believe could be as soon as the first week of Jun) to mitigate any drag that the rate hike may have on economic growth.

- The governor warned that the BI will continue to "calibrate developments, domestic and global, to make use of available space for higher rates in a measured way" but any further adjustments in monetary policy will be data-dependent. This suggests that while BI remains open to further rate hikes to stabilise the IDR, it is in no rush to do so but will act accordingly to market conditions. Our economic team expects the BI to remain on hold for the rest of the year, but we cannot rule out further rate hikes should global risks spike and destabilises the IDR. The team instead expects the BI to deliver 2 25bps hike next year to bring the benchmark policy rate to 5.25%.

- **Latest Fiscal and External Balance Outlook:** The government has revised its assumption for its budget for FY2019. It submitted to Parliament its revision for GDP to 5.4-5.8% for next year, IDR to range 13700-14000 vs. USD and oil prices in the range of USD60-70/bbl. The previous assumption put oil prices at USD48/bbl and IDR at 13400 vs. USD.

- The current account deficit narrowed in 1Q 2018, coming in at USD5.54bn (2.15% of GDP) compared to USD6.04bn in 4Q 2017 (or 2.34% of GDP). The narrower deficit was due to the improvement in the goods and services surplus (1Q18: USD0.93bn vs. 4Q17: USD0.80bn). This was due to higher deficit in the services account and also a moderation in the surplus in the goods account. The financial account surplus narrowed to USD1.81bn in 1Q compared to USD6.8bn in 4Q due to moderation in net direct investment and the outflow for net portfolio investment. Consequently, the overall balance of payments flipped to a deficit of USD3.85bn vs. a surplus of USD0.97bn in 4Q. For 2018, the BI expects the current account deficit to widen to 2.0-2.5% of GDP, but FinMin Sri Mulyani is penciling in a deficit of around 2.5%. Our economic team expects a deficit of about 2.2% of GDP.

- **Key domestic events and issues to watch**: Key focus will be BI's monetary policy meeting on 28 Jun that follows the out-of-cycle meeting on 10 May. Before that, CPI for May (4 Jun) will be eyed for signs of oil-led inflationary pressures.

- **Technical Outlook:** USDIDR more than reversed early gains into losses into month end. High was seen at 14213; last seen at 13885 levels. Momentum is turning bearish while stochastics is falling from overbought conditions. Next support at 13850 before 18738. Resistance at 13988, 14100. Bias for further downside.

PHP: BSP Facing Credibility Issues

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDPHP	52.50 (51.50)	52.50 (51.50)	52.00 (51.00)	52.00 (51.00)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The PHP failed to sustain its position as the top performing currency among the ASEANs in May. Instead, the PHP slipped back to the bottom of the pile after weakening by 1.5% against the USD in May. Aside from the rise of global risk aversion (from emerging market risks led by Turkey and Venezuela; geopolitical tensions over North Korea; and Sino-US trade tensions), domestic factors also played a role in weighing on the PHP. In particular, the apparent lack of central bank follow-through in the face of rising domestic inflation pressures and market tantrums. This reinforces the perception that the BSP remains "behind-the-curve" in anchoring inflationary expectations. This perception should keep the USDPHP supported around the 52.50 level, higher than our previous expectations for the pair to end-2Q around 51.50 and remain at elevated levels for the rest of 2018.

- The BSP appears to be a reluctant participant in tightening monetary policy. Comments by BSP officials, including the governor, seem to suggest that preference of the central bank is to not hike rates if possible. The central bank remains convinced that the acceleration in inflation is transitory and would dissipate over the course of the year. Deputy Governor Guinigundo had signaled after the policy meeting on 10 May that the one 25bp rate hike was sufficient to meet inflation target in 2019. This was followed later by Governor Espenilla that the drop in the PHP was not worrying. Together, these comments signaled to the market that the hurdle for another rate hike could be high. With market perceiving the BSP as seemingly not convicted to its tightening stance, investors could have reestablished long-USD vs. short-PHP positions, putting downside pressure on the PHP.

- Since then, Governor Espenilla has come out to warn that the BSP could raise policy rate further depending on data but market remained unconvinced. The move to cut reserve requirement by 1%-point to 18% effective 1 Jun was perceived by the market to be stealth easing by the central bank as there is a danger that this could send the economy into overdrive. This was even after the central bank noted that this cut did not suggest any change in monetary policy. All of these hints of some lack of credibility that the central bank faces in the market and this are not supportive of the PHP. There is some ways for the BSP to go to restore its credibility with the market. The PHP is likely to remain weighed around the 52.50 levels for now.

- That said, our economic team continues to expect the BSP to adjust its benchmark policy rate by another 25bp this year, most probably in 3Q 2018. The team believe that a second rate hike is needed to anchor inflationary expectations, second-round effects and avoid inflation becoming broader-based from the implementation of the tax reforms. As well, another rate hike could mitigate the risk of inflation from persistent weakness in PHP against the USD. A rate hike would be supportive of the PHP.

- To date, foreign investors have been sell-off equities the past year. To date, they have sold USD0.97bn in equities and this has weighed on the PHP. Still, there could be positive surprises coming from inflows into the stock market in 2018 once the current risk aversion episode fades. Based on our analysis using the Cyclical Adjusted P/E (CAPE) ratio model, domestic equities appears relatively cheap (as reflected by the estimated P/E ratios minus their 10-year average P/E ratios) compared to its regional peers. This is particularly given the expected strong economic performance this year. Greater inflows should thus lift the PHP higher.

- Key risks to the PHP are its twin deficits. The Philippines have yet to fix its deteriorating current account deficit problem. Aside from Indonesia, the Philippines is the only economy suffering from current account deficits. However, unlikely Indonesia, the broad trend in the current account deficit has been to the downside since 2015. The government's ambitious infrastructure building programme should keep the current account in deficit for at least in 2018 and possibly into 2019.

- In addition, risks are to the downside for overseas remittances growth due to the repatriation of Filipino workers from Kuwait and government policy on tightening immigration. This has increased expectations that remittances are unlikely to improve the current account deficit significantly. In addition, the current account deficit is likely to deteriorate further on rising oil prices (in value terms) given that Philippines is an oil-importing economy. This should work to keep the USDPHP supported above the 52-levels for now.

- As for the fiscal balance, the government's fiscal position remains a challenge. Duterte's push for tax reforms is an effort to reverse the fiscal deficits that had plague governments for the longest time. However, the ambitions infrastructure building programme of the government is likely to keep the fiscal position in deficit for now. Concerns that the government could spend more of its revenue to service interest payments rather than on development could weigh on the PHP.

- Given the largely risk-off environment in May and the perceived lack of credibility in the central bank, we have tweaked our USDPHP forecast for 2018. We now expect the USDPHP to edge higher towards the 52.50 levels by end-2Q from 51.50 previously. Thereafter, USD weakness should allow the USDPHP continue to hover around 52.50 levels (previous: 51.50) by end-3Q and then to 52.00 by end-2018 (vs. 51.00 previously).

- **Growth and Inflation Outlook:** The economy accelerated at a faster 6.8% y/y in 1Q 2018, coming in better than the 6.5% market was expecting. This could be attributed to the stronger government spending, which rose 13.6% y/y in 1Q vs. 12.2% in 4Q 2017, helping to mitigate the slower rise in private consumption (1Q: 5.6% vs. 4Q: 6.2%). This is not surprising given the government's push to accelerate infrastructure building, including bridges, subway in Manila, a new airport north of Manila and railways connecting Manila to the provinces. Altogether, the government's plans to spend PHP8tn on its infrastructure building programme that should mitigate the slowdown in contribution from exports. The government aims for growth to come in at 7-8% in 2018 bolstered by infrastructure spending. Our economic team is penciling in growth of 7.0% for 2018. For 2019, our team is looking at real GDP growth of 6.8%.

- Inflationary pressure continued to persist with headline inflation rising by 4.5% y/y in Apr, up from 4.3% in Mar. This was attributed to the sustained impact of the phase one of the tax reform measures as well as elevated food prices and utility costs. Core inflation (CPI excluding selected food items as well as energy prices) jumped by 5.0% y/y in Apr from 4.7% in Mar. Our economic team expects inflation to average 4.2% and 3.8% respectively in 2018 and 2019 (based year = 2012). The BSP is more sanguine, expecting inflation to average 3.8% and 3.0% in 2018 and 2019 respectively (base year = 2012) and 4.3% and 3.5% in 2018 and 2019 respectively (under the 2006 base-year).

- **Monetary Policy Forecast:** The BSP raised its overnight reverse repo rate by 25bp to 3.25% on 10 May to anchor inflationary expectations after headline inflation rose to 4.0% (base year=2012) or 4.6% (base year=2006) in the first four months of the year. This was at the top end of the BSP inflation target range of 2-4%. At the same time, the interest rate corridor was left intact with the overnight lending rate and overnight deposit rate holding both raised by 25bp to 3.75% and 2.75% respectively. This kept the interest rate corridor symmetrical on either side of the policy rate by 50bp. The BSP monetary policy statement suggested a "hawkish" tone with the remark that it "… stands ready to undertake further policy action as necessary …" and "… strong domestic demand allows some scope for a measured adjustment in the policy rate without adversely affecting the country's economic growth momentum". This appears to suggest a bias towards further interest rate hikes should inflation pressures remain elevated.

- However, comments by BSP officials, including the governor, were perceived by the market to suggest that preference of the central bank is to not hike rates if possible. Deputy Governor Guinigundo had signaled after the policy meeting on 10 May that the one 25bp rate hike was sufficient to meet inflation target in 2019. This was followed later by Governor Espenilla that the drop in the PHP was not worrying.

Together, these comments signaled to the market that the hurdle for another rate hike could be high.

- Since then though, Governor Espenilla has come out to warn that the BSP could raise policy rate further depending on data but market remained unconvinced. The move to cut reserve requirement by 1%-point to 18% effective 1 Jun was perceived by the market to be stealth easing by the central bank as there is a danger that this could send the economy into overdrive. This was even after the central bank noted that this cut did not suggest any change in monetary policy. All of these hints of some lack of credibility that the central bank faces in the market. There is some ways for the BSP to go to restore its credibility with the market.

- **Latest Fiscal and External Balance Outlook:** The government posted a budget surplus of PHP46.3bn in Apr – only the second surplus so far this year – helped by the strong revenue collected of PHP307.6bn vs. expenditure of PHP261.2bn. This brought the deficit in the first four months of the year to PHP105.9bn compared to the deficit of PHP152.2bn in the first three months of the year. The deficit to date though remained below the PHP220bn ceiling imposed by the government. The government remains confident that it can cap the budget deficit at 3% of GDP up to 2022.

- The balance of payments (BoP) recorded a slightly wider deficit of USD270mn in Apr compared to the deficit of USD266mn in Mar. This brought the overall BoP balance to USD1.50bn in the first four months of 2018, wider than the deficit of USD1.23bn in 1Q. The BSP though is not overly concern by this as it expects this overshooting of its estimates to be temporary and was due to the widening trade balance in 1Q. The BSP still expects the overall BoP deficit to come in at USD1bn in 2018 vs. the 2017 deficit of USD863mn. The current account is expected to also be in deficit of USD700mn in 2018.

- **Key domestic events and issues to watch:** BSP meeting on 21 Jun will be closely watched for another possible rate hike. Before that, CPI print for May on 5 Jun and Apr overseas remittances on 15 Jun will be closely watched.

- **Technical Outlook:** USDPHP traded higher for the month of May. Last seen at 52.50 levels. Bullish momentum is waning while stochastics is falling from overbought conditions. Risk of pullback not ruled out. Support at 52.20, 52 levels. Resistance at 52.75.

THB: Return Of Foreign Portfolio Investment Supportive

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDTHB	31.00 (--)	31.50 (--)	32.00 (--)	32.50 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** The THB remained one of the worst performers among the ASEANs in May. The THB weakened by around 1.4% against the USD in May, extending losses (of 1.1%) in Apr. THB weakness in May was again sparked by a combination of expectations of more rapid rise in UST yields that lifted the USD higher, and the spillover from the sell-off in emerging market risk assets, which triggered a sell-off in Thai assets as well as some unwinding of long-THB positions vs. short-USD. These factors dragged the THB to a 5-month and 2018 low of 32.363 (on 21 May) though it has since come off from that low as risk aversion plays fade. Further pullback in emerging market risks, fading geopolitical and trade tensions and unwinding of expectations for more aggressive Fed rate hikes should provide relief for the THB from downside pressures and allow a climb-back towards the 31-handle by end-2Q 2018. Our current forecast for the USDTHB had already taken into account the seasonal-weakness in the THB in May against the USD but which is expected to be temporary with the THB rebounding thereafter. We remain positive on the outlook for the THB in the near term and maintain our USDTHB forecast for the next four quarters.

- The weakness in the THB in the first half of May had been triggered by the sell-off in Thai assets for the reasons mentioned above. Since then, the sell-off has moderated. Equities continued to bear the brunt of the foreign sell-off. In May so far, foreign investors have sold USD1.38bn in equities. The sell-off in debt though appeared to have been stemmed in May. Data now reflects foreign investor purchases of USD103.8mn in May. The improvement in investor sentiments has helped the THB to roll-back some of its earlier losses. We expect portfolio flows into Thai assets to improve in the months ahead, some re-allocation of assets away from Thailand cannot be ruled out, especially should political uncertainty re-emerges in the run-up to the general elections expected early 2019. Should this happen, we could see some weakness in the THB in latter part of 2H 2018.

- Macro-economic fundamentals should continue to underpin THB strength. Persistent current account surpluses (around 10% of GDP), as well as the synchronous global and regional recovery should be supportive of the THB for the rest of 2018. So far, the synchronous global cyclical recovery has been supportive of exports and economic growth, keeping the THB supported. More importantly, we look for a pick-up in private investment to drive the next phase of growth and the THB higher. Our optimism arises from the high correlation between private investment and trade for Thailand. Thus, this current economic cycle should provide the economy and hence the THB with another leg up. In addition, the government's resolve to push forward with its infrastructure projects, especially the USD47bn Eastern Economic Corridor project ahead of general elections, could deliver upside surprises to domestic demand and growth. This investment-led recovery should be a boon for the THB.

- Risk to our THB outlook stems from political headwinds that could re-ignite downside pressure on the THB in the latter part of the year. The current calm in the political arena belie simmering political tensions. We believe that this pent-up tension could burst out into the open once the ban on political activities is lifted. This lifting of the ban is likely to come soon as the Constitutional Court has already ruled the bills on the selection of Senators and the election of MPs to constitutional. The organic bills now head to HM King Vajiralongkorn for his royal endorsement. Once the election time-line is announced in Jun, built-up political tensions in the lead-up to the election could come to a boil over concerns that civilian politicians will play second-fiddle to the military and the elites.

- The actual date for the election is expected to be announced sometime mid-year. PM Prayuth has reiterated recently that the general elections will be held sometime in the start of 2019. Previously, he had said that the polling date will be set after consultations with various stakeholders, including political parties. Still, concerns that the elections could be skewed to keep PM Prayuth and the military in power could trigger political uncertainty. In addition, should there be further delays to the general elections, political temperature is likely to rise even more and create further uncertainty in 2H 2018. This could keep investors on the sidelines until political uncertainty dissipates. Such political concerns are likely to put downside pressure on the THB in 2H 2018.

- Our base scenario is for the general elections to proceed as planned in Feb 2019. We believe that a majority government by a single party is unlikely given the new Constitution. A fractious parliament made up of smaller parties is likely with the Senate dominated by 250 members appointed by the military junta. This should allow the military to retain influence in the government as no single party will be able to command a majority. More likely than not, PM Prayuth should remain as PM as a result. We do not expect any change in economic policy direction and for the BoT to begin policy normalisation in 2H 2018. Some initial volatility is expected in the aftermath of the election but we expect the THB to stabilise and continue on its appreciation path thereafter.

- We remain broadly positive of the THB for its economic fundamentals. Near-term though, bouts of THB weakness on risk aversion plays cannot be ruled out. In addition, we caution that political tensions in 2H 2018 could stall gains in the THB. We maintain our 2018 USDTHB forecast for now.

- **Growth and Inflation Outlook:** Our confidence in the Thai economy was not misplaced. The economy expanded by a better-than-expected 4.8% y/y in 1Q 2018 (vs. 4.0% in 4Q 2017). This was the fast pace of growth since 1Q 2013. Growth was largely broad-based with private consumption, government spending and investment leading the way. The strong public investment print was the result of government-led construction of large new projects. By industries, the strong growth in agriculture sector (+6.5% y/y) was the key driver of growth in 1Q. Looking ahead, we remain sanguine over the Thai economy. Government spending ahead of the general elections together with planned infrastructure building projects including transport networks and the Eastern Economic Corridor should continue to bolster growth.

- In addition, ongoing synchronised cyclical recovery should keep exports supported in 2018 with exports on the expansion path for the 13th straight month. More importantly, we look for the export-led recovery to spark a revival in private investment that should sustain growth in 2018, given the high correlation between export recoveries and machinery & equipment investments for Thailand. With the economy on sustained rebound, the NESDB has upgraded its 2018 growth forecasts to 4.2-4.7%, up from 3.6-4.6% previously. Our economic team expects the economy to expand by 4.5% in 2018.

- Headline inflation crossed the 1.0% levels for the first time since Feb 2017 when it rose by 1.07% y/y in Apr vs. 0.79% in Mar. Key drivers of higher inflation in Apr was food prices, which rose 0.68% y/y vs. 0.9% in Mar. Supportive of consumer prices as well were housing and transport cost, which climbed 1.50% and 1.41% in was little changed, rising 0.64% in Apr compared to 0.63% in Mar, though this was still the highest since Jan 2017. While it targets headline inflation to fall within the 1-4% range for 2018, the BoT is forecasting headline inflation to come in at the bottom of its forecast range at 1.0% in 2018. The Commerce Ministry expects inflation to average 1.14% in 2018, while the Finance Ministry is penciling in 1.2%, both of which are near the lower end of the BoT's forecast range. Our economic team also does not expect significant upside pressures on consumer prices in 2018, expecting headline inflation to average 1.3% in 2018.

- **Monetary Policy Forecast:** The BoT has kept its current monetary policy stance since Apr 2015. At its most recent meeting on 16 May, the BoT held its benchmark policy rate - the one-day repo rate - steady at 1.5%. The last time the policy rate was even lower was during the Great Financial Crisis in 2009 at 1.25%. The current environment of economic recovery amid a modest inflationary environment has enabled the BoT to keep its policy rate at current levels. With inflationary pressure benign, the focus of the BoT is centred on growth and accommodative monetary policy would be appropriate to support growth. This was reflect in BoT's emphasis that that it stood ready to utilize available policy tools to sustain economic growth while ensuring financial stability. Despite the BoT's comments, our economic team continues to look for the BoT to normalise this year amid a pick-up in inflationary pressures. They expect such a move to take place in 2H 2018.

- **Latest Fiscal and External Balance Outlook:** The government expects the budget deficit to peak in FY2021 at THB540bn underpinned by expected revenue and expenditure of THB2.76tn and THB3.3tn respectively. The deficit is expected to ease the following year as the government embarks on plans to resize its employment pool and boost efficiency in tax collection. The public debt-to-GDP ratio is projected to rise to 47% of GDP in 2021 and then peaking at 49% in 2022. The current public debt-to-GDP is at 41.2%.

- The current account surplus narrowed even more to USD1.36bn in Apr from USD5.75bn in Mar. The weaker surplus was due to the sharp moderation in the trade balance to USD0.23bn (Mar: USD3.02bn) in Apr and smaller income account surplus of USD1.13bn (from USD2.74bn in Mar). The overall balance of payments narrowed to USD0.89bn in Apr vs. USD2.97bn in Mar. While details are unavailable at the moment, we believe that the strong investment outflows could have account for the milder overall BoP surplus in Apr.

- **Key domestic events and issues to watch:** May CPI print on 1 Jun will be followed for clues on any BoT moves. BoT meets to decide on monetary policy on 20 Jun.

- **Technical Outlook:** USDTHB partially retraced gains into month end. Pair was last seen at 31.99 levels. Momentum on daily chart turned mild bearish with stochastics falling. Further downside not ruled out. Next support at 31.88 (38.2% fibo retracement of Apr low to May high), 31.73 (50% fibo). Resistance at 32.06 (23.6% fibo) before 32.20 (200 DMA).

INR: The Snapback Is Strongest for the One Most stretched

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDINR	66.00 (64.00)	65.00 (64.00)	64.00 (63.50)	63.00 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The tide is turning for the INR, at least in the short-term. As the one that was hammered the most in the past few weeks in an environment of rising USD, UST rates and oil prices, INR could stand to snap back the most amongst the regional currencies. Near-term, we could see USDINR heading lower towards the 67.20 (23.6% Fibonacci retracement level) before the next at 66.45. The release of the FOMC Minutes and the price action that followed suggests that 1) a June Fed hike is more or less in the price and 2) more than three hikes is less likely. Moreover, the fact that the Fed is considering to implement a 20bps increase in IOER at a time when the FOMC raises the target range by 25bps suggests that the Fed is keen to slow the rates increase and could be a reason for the 19bps drop for the UST 10y yield from its high of 3.12% last week (last checked on 28 May). Just as how we have turned very cautious on the rupee due to the crude surge, the change of environment for crude with Saudi Arabia increasing output to vie for more market share, and even shifting their IPO to 2019 (from this year), is supportive of the rupee. The rupee should have moved a lot more if not for concerns over EM contagion risks emanating out of Turkey and Argentina as well as the Italian political risks that weigh on the EUR and support the USDINR. We shift our forecast to 66.00 for 2Q along with the forecasts for the rest of the year.

- **Growth and Inflation Outlook:** Industrial production growth slowed surprisingly to 4.4%y/y for Mar, weighed by the sharp deceleration in manufacturing growth which fell from 8.5%y/y in the month prior to 4.4%. Also, capital goods registered a contraction of -1.8%y/y after a three consecutive months of double digit growth. Consumer durable goods also slowed markedly to 2.9%y/y from previous 7.5%. With the contraction in the capital goods likely due to the high base effect, expect a rebound in the headline as the base effects fade into the second quarter. In fact, the Nikkei mfg PMI for Apr report improving operating conditions in Apr with accelerations in output growth and new orders expected and even a "renewed rise in employment". This underpins the strong growth forecasts that RBI projects at 7.4% for FY2018-19.
- **Meanwhile, p**rivate consumption could moderate from the 10%y/y growth seen in quarter ending Dec 2017 as an inflationary environment might crimp on spending power. The boost to the household spending from the increase in the minimum support price may be negated by the fact that it could also add to price pressure. Apr CPI beat expectations of 4.40%y/y with a print of 4.58%y/y vs. the previous 4.3%. Interestingly, the rise in price pressure was due to the rise in housing prices and clothing and footwear. Food costs have come off marginally from 3.1%y/y to 3.0% due to the good rabi harvest. The impact of crude on fuel and light has not come into effect yet. On the side of the manufacturer, WPI also rose more than expected to 3.18%y/y from previous 2.47%.
- **Monetary Policy Forecast:** RBI did not meet for monetary policy decision in May but the next policy decision will be next week, 6th Jun. After an upside surprise in the inflation numbers, we see a real risk of the central bank to raise reverse repo rates by 25bps at this meeting. Note that at the Meeting in Apr, RBI had been hawkish because according to their regular reports, households' inflation expectations, reported by the Mar 2018 round of survey of households, rose for both 3-month and 1-year ahead horizon. Manufacturing firms in the Industrial Outlook survey also reported higher selling prices in the last quarter of the FY 2017-18. Looking forward, RBI held its CPI forecasts at 5.1% for 4Q of FY2017-18 and in the range of 5.1-5.6% in the first half of the FY2018-2019, 4.5-4.6% in H2 taking into account the impact of HRW with risks tilted to the upside. Excluding the impact of HRA, CPI is forecasted to be 4.4-4.7% in H1 of 2018-19 and 4.4% in H2. There were a number of factors listed by the RBI that could quicken the pace of economic activity over this year (2018-19), counting on signs of rising investment, improving global demand. The

central bank expects output to close and GDP is projected to strengthen from 6.6% in 2017-18 to 7.4% in 2018-19.

- The recent release in inflation data has validated RBI's concerns and the effect of higher oil prices were not even taken into account in the recent inflation data yet. Risks to CPI are to the upside but we can take comfort that crude seems to be correcting lower in the medium term and that could at least provide some anchor for inflation expectations. Nonetheless, with output gap projected to close in the year 2018-19 and inflation likely rise, hawkish RBI might choose to act next week to ensure it is ahead of the curve and to arrest the decline in the INR that undermines the inflation expectations even more.
- **Latest Fiscal and External Balance Outlook:** Finance Minister announced that the fiscal deficit for FY17 is poised to come in at 3.5%, well above the 3.2% projected as tax collections following the implementation of GST was lower than expected. For the coming year, the government estimates fiscal deficit to improve to 3.3%.
- Brent prices hovered around $75/bbl levels at last sight (28 May) after breaching the U$80/bbl earlier this month. Technically, brent could correct lower and a 10% correction in brent towards the U$67 could bring the USDINR towards the U$64/bbl according to a ordinary least squares analysis. We think a continued pullback in the UST rates would trigger even more unwinding of long USDINR position. Hence, we would prefer to hold the USDINR forecast at around U$64.
- **Key domestic events and issues to watch:** 1Q GDP on 31st May; PMI-mfg for May on 1st Jun; 1Q current account anytime between 5-29th Jun; RBI decision on the 6th; Apr IP and May CPI on the 12th; WPI on 14th; trade data on 15th;
- **Technical outlook:** We had put out a trade to sell the USDINR 1M NDF at the reference rate of 67.95 towards a target of 66.79. Stoploss at 68.40. MACD is gathering bearish momentum and we look for a break of the 67.60-support for further downside. Core PCE out of the US is awaited. In addition, an RBI hike next week could give boost to rupee bulls.

VND: Not Immune to External Volatility

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDVND	22800 (22750)	22750 (--)	22740 (--)	22780 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** USDVND surged in the last week of May, buoyed by the EM sell off in reaction to the Italian political uncertainty. There are concerns on inflation at home with the May print surprising to the upside. The move higher in USDVND also coincides with the recent rally of the USDCNH and VND even strengthened against the CNY marginally for the month, at last check

(31 May). We tweaked the 2Q forecast to take into account what has happened in the month so far.

- Still, we do not expect the VND NEER to gain much as Vietnam is likely to keep VND slightly weaker to boost exports growth and increase the allure of its domestic assets to foreign investors. Guiding the dong weaker ensures an element of stability and control in the exchange rate that could be reassuring for investors. The NEER management could mean that dong could still be swayed by external volatility, especially when it comes to moves in the USDCNH.
- With that in mind, VND is likely to remain weaker against its regional peers. However, we are still looking for USD to remain on its mild downtrend in the medium term and that could see USDVND slightly bias to the downside into the end of the year. It is worth noting that visitor arrivals from China continue to remain in double digit growth. That could really underpin the exports of services and another reason for VND to remain competitive.
- In a backdrop of broad USD downtrend, we see mild downside risks to the USDVND towards 22740 by the end of this year. Yet, the appreciation is likely to lag that of key trading peers like CNY, JPY, THB and SGD. With inflation creeping higher, SBV might choose to keep VND competitive to boost exports and FDIs. We look for VND to head lower towards 3610 against CNY, 219 against the JPY, 17492 against the SGD by year end.
- Separately, Deputy Premier Trinh Dinh Dung said that Vietnam has decided to restructure the industry sector such that the industry and construction sectors could represent 30-35% of GDP by 2020 instead of the originally set 42-43%. Beyond 2020 to 2025, the industry sectors should be maintained at over 35% of GDP. This could mean a more diversified economy.
- **Growth and Inflation Outlook:** Markit reported a rather strong number for the manufacturing sector at 52.7 vs. the previous 51.6. According to the respondents, growth momentum accelerated in Apr and there were sharper gains in output, new orders and employment. Interestingly, there were mentions of "particular strength" in the export market for Apr but that did not follow through as May's exports print was softer. Vietnam registered a trade deficit of U$500mn in May vs. the U$700mn last month. Industrial production also came off to 7.1%y/y from previous 9.4%, weighed by the contraction in mining output though manufacturing output actually gained momentum from 4.7%y/y to 9.4% in May. The electricity sub component also slowed to 13.1%y/y from previous 15.5%.
- Retail sales picked up pace for May with the growth quickening to 10.1%y/y for Jan-May from 9.8% in the first four months. Visitor arrivals are still in high double digit growth, notwithstanding the slowdown in May. We anticipate domestic demand to remain supported though price pressure could crimp. CPI surprised to the upside for May to 3.86%y/y from previous 2.75%, firmer than the expected 3.40%. Food costs actually accelerated in the month along with housing and construction while healthcare inflation remains elevated. Deputy Premier Vuong Dinh Hue has ordered Ministry of

Health to cut the cost of health-care services starting from 15th Jul. Electricity prices are also supposed to be capped this year, as instructed by the Ministry of Industry and Trade.

- **Monetary Policy Forecast:** We do not see much room for SBV to cut rates given the fact that food inflation remains a threat. However, as we have stated in this note, the NEER has come off significantly and the VND actually stabilized in May. We do not think this could be the start of a recovery in the NEER as exports had taken a hit in May. We anticipate that SBV could continue to keep this VND weak against trading partners to boost trade as well as to attract foreign direct investment into the country. In fact, FDI had a rather strong growth of 54.6%y/y in May and that could continue to rise. Toyota Vietnam has proposed a plan to add 9hectares of expanded car production lines in Vinh Phuc province. That could raise production to 90k units/year in 2025 from the current 50k/yr (BBG). This came after news that Toyota Vietnam General Director saying that the company may consider importing cars to benefit from the scheduled ASEAN tariff reduction and close the production in Vietnam.

- **Latest Fiscal and External Balance Outlook:** Vietnam's fiscal position is likely to remain in consolidation mode as fiscal deficit remains wide. The National Assembly stated that the average state budget deficit planned is estimated to be 3.7% of GDP for 2018 and NFSC commented earlier this month that the budget is on track to meet that target set. The government needs to fund state budget deficit of VND 206.15trn and pay principal loans of CNY157.13trn this year. The government aims to reduce budget deficit to 3.5% of GDP by 2020.

- Current account recorded a sizeable surplus of USD3.1bn in 4Q last year, narrowing from the previous U$4.3bn. This data comes from smaller trade surplus of goods of U$4.93bn (vs. prev. U$5.22bn). The competitive dong could keep the current account in surplus.

- **Key Domestic Events and Issues to Watch:** PMI Mfg on the 1st; domestic vehicle sales in 6th-13th; CPI, trade numbers, retail sales, IP and 2Q GDP are due 25th-30th.

FX Forecasts

	End Q2-18	End Q3-18	End Q4-18	End Q1-19
USD/JPY	109	106	104	104
EUR/USD	1.1700	1.1900	1.2200	1.2400
GBP/USD	1.3400	1.3800	1.4000	1.4200
AUD/USD	0.7700	0.7800	0.8000	0.8000
NZD/USD	0.7100	0.7300	0.7400	0.7500
USD/SGD	1.3300	1.3100	1.3000	1.2900
USD/MYR	3.9500	3.8500	3.8000	3.8000
USD/IDR	13800	13600	13500	13400
USD/THB	31.00	31.50	32.00	32.50
USD/PHP	52.50	52.50	52.00	52.00
USD/CNY	6.40	6.35	6.30	6.25
USD/HKD	7.84	7.80	7.80	7.80
USD/TWD	29.60	29.50	29.40	29.20
USD/KRW	1065	1060	1055	1050
USD/INR	66.00	65.00	64.00	63.00
USD/VND	22800	22750	22740	22780
DXY Index	94.03	92.14	90.28	89.37
SGD Crosses	End Q2-18	End Q3-18	End Q4-18	End Q1-19
SGD/MYR	2.9699	2.9389	2.9231	2.9457
SGD/IDR	10376	10382	10385	10388
SGD/THB	23.31	24.05	24.62	25.19
SGD/PHP	39.47	40.08	40.00	40.31
SGD/CNY	4.81	4.85	4.85	4.84
SGD/HKD	5.89	5.95	6.00	6.05
SGD/TWD	22.26	22.52	22.62	22.64
SGD/KRW	801	809	812	814
SGD/INR	49.62	49.62	49.23	48.84
MYR Crosses	End Q2-18	End Q3-18	End Q4-18	End Q1-19
EUR/MYR	4.62	4.58	4.64	4.71
JPY/MYR	3.64	3.63	3.65	3.65
MYR/HKD	1.98	2.03	2.05	2.05
MYR/CNY	1.62	1.65	1.66	1.64
GBP/MYR	5.29	5.31	5.32	5.40
AUD/MYR	3.04	3.00	3.04	3.04
NZD/MYR	2.80	2.81	2.81	2.85
MYR/IDR	3493.67	3532.47	3552.63	3526.32
MYR/INR	16.71	16.88	16.84	16.58
MYR/KRW	269.62	275.32	277.63	276.32
MYR/PHP	13.29	13.64	13.68	13.68
CNY/MYR	0.6172	0.6063	0.6032	0.6080

Source: Maybank FX Research as of 31 May 2018

*These forecasts are meant to be indicative of FX trends and not meant to be point forecasts.

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