May 31, 2019

# FX Monthly

# 2019, Issue 5: Trudging Through the Rifts

## What Has Changed This Month?

- We adjusted USD broadly higher against most AXJs including AUD, NZD to reflect the recent change in market environment - escalation of trade tensions resulting in fading hopes for US-China trade deal this quarter - but we stop short of pricing in a lot more USDAXJ upside beyond 3Q as most of the overshooting may have been frontloaded. We also revised GBP lower to reflect the fresh political uncertainties - change in leadership and potentially brexit process and EUR lower to price in delayed timeline for ECB to normalize policies and renewed political uncertainties following recent European Parliamentary elections.

## Our Strategies

- Market environment has shifted in May since the last FX Outlook as trade tensions between US and China unexpectedly re-escalated and broadened to technology and FX. Both countries raised trade tariff rates; US forbid US companies from doing business with foreign companies that pose threat to national security, including Huawei while China said it have plans to curb sales of rare earth material to US if needed.
- Given the fluid US-China trade situation currently, our base case scenario is a "grey swan" type amid the re-escalation in "tit-for-tat" tariffs and non-tariff actions that diminish the prospect of a US-China trade deal anytime soon, resulting in a protracted period of tension, although "lines of communication" remains open. As US-China trade and tech war continues into 2H 2019 and as statistics on the "casualties of war" relating to growth, trade, corporate earnings, financial market stresses will start to pile up, these could eventually compel US and China to return to the negotiation table. Progression on talks taking both sides closer to a deal in late-2019/early-2020 is not impossible and this could help support sentiment and support our view for trade/tech-linked FX to recover.
- We reiterate our call looking for DXY strength to ease into end-year. True that market typically buys USD on fears of no trade deal, etc. But we argued that trade tensions can also hurt US growth, jobs creation and financial markets. Potentially the Fed may even need to ease monetary policies at some stage. In this environment where US growth/activity outlook starts to dim, flight to quality flows/ equity sell-off should favor JPY and CHF while EUR could somewhat retain its relative resilience. As a result DXY strength could be curbed.
- But for USD vs. AXJs, that may not be the case. Trade war is still ongoing at least until the next G20 meeting in Osaka (28-29 Jun). Trump said that US is not ready to make a trade deal with China while China wants US to show sincerity. With war on trade spreading to technology, we see depreciation pressure for trade/tech-linked AXJ FX such as CNH, KRW, TWD, SGD, MYR, AUD and NZD.

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**Top 3 Currency Plays for Jun**

*Defensive FX plays: Long JPY, CHF vs. Shorts in KRW, TWD, CNH*

*Fade The Dollar Index Up-move*

*Sell USDJPY on rally*

**Key Events for the Month Ahead**

| Date | Event |
|---|---|
| 1 Jun | China increases tariff on $60bn of US good takes effect |
| 7 Jun | PM May to resign from office |
| 25 - 26 Jun | OPEC meeting, Vienna |
| 28 - 29 Jun | G20 Summit in Osaka where President Xi and Trump may potentially meet |

***We wish our readers a Selamat Hari Raya Aidilfitri!!***

# G7 Global Overview

## USD: Hard to Maintain Altitude

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
| --- | --- | --- | --- | --- |
| USD Index | 98.18<br>(96.18) | 97.20<br>(95.18) | 96.88<br>(95.40) | 96.55<br>(94.87) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** Our DXY forecast was calibrated due to the broad upward dollar revisions on the back of the recent negative escalation of the US-China trade negotiations. We reiterate our call looking for DXY strength to ease lower. True that market typically buys USD on fears of no trade deal, etc. But our argument is that trade tensions can also hurt US growth, jobs market and potentially the Fed could be forced to ease monetary policies at some stage. In this environment where US growth/activity outlook starts to dim, flight to quality flows/equity sell-off may even favor JPY and CHF while EUR could somewhat retains its relative resilience. As a result DXY strength could be curbed. As such, we continue to look for USD to come off slightly into 4Q 2019.

- But for USD vs. AXJs, that may not be the case. There is chance for AXJs to gain some breather especially after warnings from Korea, China regulators over the past few days and that US recent proposal for tariff on imports coming from countries with undervalued FX. This may deter Asian FX from depreciating too quickly for fear of being subjected to tariff imposition.

- But trade war is still ongoing at least until the next G20 meeting in Osaka (28-29 Jun). Trump said that US is not ready to make a trade deal with China while China wants US to show sincerity. With war on trade spreading to technology, it does look like AXJs in particular those trade and tech-linked ones such as KRW, CNH, TWD, SGD could remain on the back foot. So for USD against those AXJs, one may be better off buying USD on dips. But if we strip out the USD component, this leaves us with long EUR and JPY vs. short in AXJs in this trade war environment

- **Risks to our Outlook:** (1) the risk of further gains in oil prices (possibly due to supply-disruption emanating out of Middle East/Iran tensions or material progress on US-China trade deal) could translate into inflation ticking higher in US and this could reignite pressure for Fed to tighten and would be supportive of the USD (recall that oil prices and USD rose in tandem in 2018); (2) no US-China trade deal and lack of follow-through (pick-up) in global economic activity could result in a deeper economic slowdown. In this scenario, volatility will jump from current compressed levels and risk assets including equities will enter into a deeper sell-off and USD could strengthen (flight to safety); (3) if growth and monetary policy divergence resumes in favor of US, then concerns about tighter monetary conditions could expose vulnerabilities in EM assets including Turkey, Venezuela (spillover contagion) and USD could then be poised for further upside (risk-off trade).

- **Growth and Inflation Outlook:** 1Q GDP came in much better than expected (+3.2% q/q vs. +2.3% expected vs. +2.2% in 4Q). However devil appears to be in the details as the breakdown shows inventories and net trade boosted headline GDP while consumer spending was weak. Final sales to domestic purchasers ex-inventories and trade (as proxy for underlying growth trend) saw a sharper slowdown to 1.4% in 1Q (down from 2.1% in 4Q. This marks the weakest quarterly print since end-2015. It is probably no surprise that USD gave up knee-jerk gains to trade lower on the back of slowing momentum in underlying growth.

- Mar PCE core coming in softer (+1.6% y/y) than expected (+1.7%) further confirmed the benign inflationary environment in US. Prices for healthcare services fell 0.2% in Mar after rising 0.3% in Feb while cost of apparel also fell. Taken together, weaker-than-expected US data including softer retail sales, industrial production, core PCE, Chicago PMI, factory orders, 4Q GDP warrant Fed's patience on policy normalisation.

- US data came out weaker in May, with housing data, durable goods orders, US PMI, Industrial Production, retail sales lower than expected.

- **Monetary Policy Forecast:** FFTR is expected to remain on hold at 2.25 - 2.5% at the upcoming FoMC (18-19 June). We also expect the Fed to **reiterate its patience stance and data-dependence approach**. Any deviation from its previous communicated stance could see USD react. We think there is a small risk that the Fed could bring forward the timeline (slower pace of reduction from May with a complete stop in Sep) of balance sheet reduction or tweak details. This if it happens, would add to Fed's dovish rhetoric. Our **House view is now looking for FFTR to remain unchanged at 2.25 - 2.5% for 2019 - 2020**.

- Putting the current Fed rate hike cycle in perspective, the Fed started normalising monetary policy on Dec-2015 and since then, the Fed has raised Fed funds target rate on 9 occasions by 25bps each over 40 months. Going by Fed's forward guidance, only 1 more rate hike is expected in 2020 while markets are even pricing in a 53% chance of a 25bps rate cut as early as at the Oct-2019 FoMC meeting. We believe the Fed is nearing its end of policy normalisation (previously highlighted in our earlier report). Going back to 1980s, previous episodes of yield curve inversions tend to coincide with the peak of each Fed rate hike cycle. In the current episode, the low of 2Y10Y UST yield spread was about +10bps away from being flat (before steeping to +23bps in Apr). Historically the low in 2y10y yield spread was about -40bps in 1989 and 2000. While there may still be room for Fed to tighten, historical observation suggests that the room may well be limited.

- On balance sheet normalisation, Fed plans to slow the pace of normalisation in May and end normalisation in Sep. Financial conditions are expected to ease. Fed Chair Powell added that rates could be on hold for "some time" as global risks weigh on the economic outlook and inflation remains muted.

- Despite Fed's assessment that the labour market conditions remain tight, view on growth is toned down as economic activity moderated amid slower household spending and business fixed investment, coupled with muted inflation. Fed is also monitoring global economic and financial developments. Fed's latest 2019-2021 median macro forecasts (as of 21 Mar) showed slight downward revisions to growth and headline inflation rates, no change in the forecast of steady core inflation rate at 2.0%, and marginal upward revisions in the still sub-4% unemployment rate.

- In a separate statement on "Balance Sheet Normalisation Principles and Plan", Fed now plans to slow the reduction of its US Treasury holdings from current USD30b a month to USD15b a month starting May 2019 and end the reduction process in Sep 2019. At the same time, Fed will continue with its plan to reduce its holdings of agency debt and agency mortgage-backed securities (MBS). However, starting Oct 2019, Fed will re-invest principal payments from these securities into US Treasuries at a maximum amount of USD20b per month, with any excess plough back into agency MBS. We expect this to result in a relatively "flat" Fed's balance sheet from 4Q 2019 onwards.

- **Latest Fiscal and External Balance Outlook:** The portion of the shutdown at the end of Q4 will likely lead to some loss but we could see some of the loss in activity emerge in 1Q 2019 in the form of investment spending. Overall, growth in US economic activity is likely to slow toward trend as the impulse from the fiscal stimulus fades. The tax plan has not generated a sustained pickup in investment spending. The tax cut and Jobs Act are likely to widen deficit by about $1.5trn over 10 years. The bipartisan budget Act of 2018 to add $320mn in additional spending through FY 2020.

- **Key domestic events and issues to watch in June:** ISM mfg (3 June); Factory orders, durable goods orders (4 June); trade balance (6 June); NFP (7 June); May CPI (12 June); May retail sales (14 June), May empire manufacturing (17 June); FoMC (20 June); new home sales (25 June); GDP qoq (27 June); PCE deflator (28 June).

- **Technical Outlook:** DXY drifted lower in early-May to 97.02 (13 May), which was in line with our last Month's tech outlook looking for a move towards 97.30, 97 levels. But subsequently, losses in DXY were reversed into month-end. Last seen at 98.1 levels. Mild bullish momentum on daily chart remains intact while stochastics has risen into near overbought conditions (on weekly charts). Immediate resistance at 98.3 levels (interim triple top) remains intact. Bias to lean against strength. Support at 97.4 (50 DMA), 96.9 (100 DMA) and 96.50 (200 DMA).

## EUR: Will the EUR Short Squeeze Come in Jun?

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| EURUSD | **1.1150** (1.1500) | **1.1200** (1.1600) | **1.1250** (1.1600) | **1.1300** (1.1600) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** We lowered EUR forecast for the next 3 quarters to reflect and to price in potential market development which include (1) the risk of fresh political uncertainties post-EU parliamentary elections; (2) bearish sentiment on risk assets and global growth, trade outlook owing to re-escalation in US-China trade tensions; (3) potential risk of US imposing tariffs on auto imports from EU (which is now deferred for 180 days but could still pose downside risks if the subject is broached again); (4) delayed expectation for ECB to normalize policies as the downside risk of external shocks may have increased; as well as (5) Italy-EU budget stand-off we European Commission is considering to propose a disciplinary procedure for Italy (possibly as soon as 1st week of Jun) due to Italy's failure to keep debt under control. This could possibly result in a EUR3.5bn penalty for Italy. While the decision has yet to be finalised, Italy bond yields have risen with 10Y rising 20bps higher to 2.73% high (28 May). This is another factor that could further drag EUR lower.
- Results of the European parliamentary elections saw centre-right European People's Party (EPP) took pole position with 23.8% of votes while Socialist & Democrats (S&D) took second place with 20.4%. Though both parties retain their majority in parliament, their shares of votes have been reduced while populist parties Liberals and Greens posted their biggest gains with 14.2% and 9.2%, respectively. For Italy, Deputy Premier Salvini's party was handed a clear victory over coalition partner Five Star Movement party. That would have triggered Deputy Premier Salvini to call for early election if not for the smaller than expected margin of victory. In France, President Macron's party lost to Marine Le Pen's National Rally while Greece's PM Tsipras suffered a defeat to the main opposition New Democracy party. These provisional results suggest that the risk of fresh elections possible in France while Greece will hold early elections in on 7th Jul (previously scheduled for 20th Oct). Rise in political risk premium could limit EUR recovery. In addition leadership changes (change of Conservative party leader, PM and possible fresh GE or second Brexit referendum) in UK may also weigh on EUR as well. But bear in mind that political uncertainties typically subsides after key event dates and the unwinding of political risk premium then could support EUR's recovery.
- **Despite lowering our EUR forecasts, we are keeping the mild upward trajectory intact over the forecast horizon to reflect our constructive bias.** For the upcoming month, we see technical chance of EUR short squeeze higher, possibly towards 1.1280, 1.1380 (200 DMA) as many EUR and market-negatives may have been priced in to large extent (EUR shorts position, as shown in CFTC positioning has risen to 2.5-year highs) and the green shoots story for EU-area

remains intact (concerns with the pace of recovery however remain). On the other hand, concerns of political uncertainties in EU and US-China trade war (sentiment, global growth channels) could limit EUR's recovery. Support at 1.1107 (interim double bottom), 1.1050 likely to hold for Jun.

- Our mildly constructive outlook for EUR over our forecast horizon (hence the upward trajectory in EUR forecasts) is premised on signs of green shoots of recovery in Euro-area though recent data is a bit more mixed, compared to the prior month.
  - Further stabilisation in EU data, in particular coming from Germany (which has seen a soft patch) could provide the confidence for potential portfolio reallocation in favor of EU assets and this could provide the recovery for EUR.
  - Though ECB's timeline of policy normalisation may have been pushed back, Fed's pause on rate normalisation and slowdown in balance sheet normalisation (starting May and ending in Sep), could help to further reduce the negative EU-UST yield differentials. This divergence-convergence of ECB-Fed policies, albeit slow pace, is another factor supportive of EUR recovery. We expect EUR gains to pick up traction when ECB policy normalisation plans kick in at some stage towards end-2019-early-2020.
  - As trade war between US and China continues into 2H, statistics on "casualties of war" relating to growth, corporate earnings, financial market stresses will start to pile up, and these could eventually compel US and China to return to the negotiation table. Progression on talks taking both sides closer to a deal into the turn of the year is not impossible and this could help support sentiment. Chance for US-China trade deal into the close of the year could also be a factor supporting the stabilisation story in China and Europe. Taken together, this could support EUR recovery.

- **Downside Risks to Outlook:** EUR could be vulnerable for further downside if (1) hopes of green shoots of recovery in Euro-area proved short-lived; (2) a prolonged delay in ECB policy normalisation plans into 2H 2020; (3) negative political surprises such as early elections in Italy, France, UK, Brexit uncertainties, etc. dragging on for longer; (4) US imposition of import tariff on EU autos.

- **Growth and Inflation Outlook: 1Q Euro-area growth picked up pace to +0.4% q/q in 1Q (up from +0.2% in 4Q vs. 0.3% expected).** Data came as a welcome relief as Italy emerged out of recession (+0.2% w/w vs. -0.1% in 4Q) with growth seen in most sectors including agriculture, industry and services; Spain's growth momentum accelerated (+0.7% q/q vs. +0.6% in 4Q); France held ground at +0.3% q/q and Germany shake off fears of recession (+0.4% q/q in 1Q vs. 0% in 4Q).

- Looking on, s**igns of growth stabilisation in the Euro-area remain mixed:**

- German factory orders rebounded in Mar but pace of growth was softer than expected (actual +0.6% m/m vs. -4.2% prior month vs. +1.4% expected);
- German and Euro-area composite preliminary PMI held steady at 52.4 and 51.6, respectively;
- Industrial production for Euro-area, including Italy, France and Spain disappointed to the downside but Germany surprised to the upside (+0.5% vs. -0.5% expected);
- Unemployment rate fell to more than decade low of 7.7% for Mar-2018 (vs. 7.8% in Feb). Compared with a year ago, the unemployment rate fell in all member states. Lowest unemployment rates seen in Germany (at 3.2%) and Netherlands (at 3.3%) while highest unemployment rates were seen in Greece (at 18.5%), Spain (at 14%) and Italy (at 10.2%).

- No doubt Germany is undergoing a soft patch for now, we believe this is one-off and the economy should recover once the one-off soft patch relating to auto emission scandal fades. We believe further stabilisation in EU data, in particular coming from Germany could translate into a real pick-up for the Euro-area.

- The latest ECB macroeconomic projection will be released in the ECB report on 6th Jun. The last quarterly report (Mar 2019) shows that growth **projections were revised much lower to 1.1% and 1.6% for 2019 and 2020,** respectively (vs. 1.7% as previously projected in the last quarterly assessment). Investments and exports saw the main revision lower. **Inflation was also** revised much lower to 1.2% (vs. 1.6%) for 2019 and **revised lower to 1.5% for 2020 (vs. 1.7% previous projection).**

- **Headline Euro-area CPI picked up pace to 1.7% in Apr** (vs. 1.4% in Mar). The acceleration in headline prices was due to energy and services while late timing of Easter may have distorted priced for some holiday-related components such as hotels and travel. The rise was well within our call (in the last FX Monthly) that CPI could rise amid holiday effect and higher oil prices. Looking ahead we now see chance the higher print may possibly be partially reversed out in the May reading. Nonetheless this is the strongest pace since Nov-2018. Core inflation was also up at 1.2% in Apr (vs. 0.8% in Mar). Going forward the ECB expects inflation pressure to gradually rise owing to favourable labor market dynamics (falling unemployment and rising wage growth).

- **Monetary Policy Forecast: The next ECB GC meeting is scheduled on 6th Jun.** We expect ECB to reiterate its commitment to maintain key policy rates including Main Refinancing operations, deposit facility and marginal lending facility on hold at 0%, -0.4% and 0.25%, respectively till end-2019. Further details on the terms and conditions for 3rd tranche of TLTRO (announced in Mar-2019 and starting in Sep-2019) is expected at the Jun GC. We do not rule out another dovish tilt as recent ECB minutes indicated that ECB policymakers seem concerned that Euro-area growth is weaker than feared as ECB acknowledged that “recent data had turned out even weaker than expected and there was now somewhat less confidence in the baseline scenario for growth and that the range of other possible outcomes had widened". But cutting policy rate or unleashing further stimulus does not fall within our expectations as inflationary pressure remain evident and growth slowdown in German is likely one-off and current policy accommodation and TLTRO as backstop are sufficient.

- That said our base case expectation for ECB to normalize policies is now deferred to 1H 2020. We expect ECB to keep policy rates on hold for 2019 and possibly proceed to normalize policy sometimes in 1Q 2020 with modest increase in deposit rate from -0.4% to -0.3% should (1) inflation data, in particular core CPI continue to trend higher while (2) recent decline in growth and activity data proved to be one-off; (3) trade tensions between US and China simmer.

- **There was no ECB Governing Council meeting in May.** In the last ECB Governing Council meeting (10th Apr), policy rates and forward guidance for rates to remain at present levels through end-2019 were left intact as widely expected. The ECB sounded dovish. Draghi acknowledged that the economic weakness had proved 'somewhat longer lasting' than previously expected and ECB is willing and able to act is Eurozone economy remains weak. He added that ECB could even tolerate a period of above-target inflation in order to put the economy back on track. On market speculation of the possibility of a tiered deposit scheme, Draghi confirmed that policymakers were considering measures to mitigate the impact on banks of its negative deposit rates but it remains too early to decide as they need further information that will come in between now and June. In short, Draghi's overnight comments may appear dovish and could possibly raise the risk of further rate cut but we doubt if a cut would materialise as signs of stabilisation are already showing up in European activity including German survey expectations.

- ECB President Draghi will step down on 31 Oct 2019 and the race for the next ECB President is likely to intensify after EU parliamentary elections (26th May). The Bloomberg survey of Economists now put French Governor Francois Villeroy, Former ECB GC member Liikanen, ECB member Coeure, Finland Governor Rehn and German Governor Weidmann as the top 5 contenders. Both Liikanen and Villeroy are considered close aides of Draghi and are supportive of accommodative monetary policies while Weidmann is typically viewed as a hawk. The latter recently said he opposed to adding any extra stimulus for the Euro-area; economic momentum is slowing from very high level citing Germany as an example where capacity is overstretched while price pressures remain and is not in a situation that needed to be met with further stimulus.

- At the ECB GC meeting (7th Mar), ECB announced its decision to (1) re-introduce cheap funding via quarterly TLTRO with rate indexed to MRO interest rate (currently at zero) starting in Sep-2019; (2) shifts in forward guidance on policy normalisation – ECB now expect rates to remain at present levels through end-2019, from end Summer-2019 and (3) relatively large downward revisions to 2019 growth forecast to 1.1% from 1.7%.

- **Latest External Balance Outlook:** Euro area's current account surplus further narrowed to EUR24.7bn in Mar (vs. EUR27bn in Feb). Euro-area current account surplus was 2.9% of GDP, down from 3.3% in the same period a year ago. ECB expects current account surplus to narrow further to 2.7% of GDP in 2019 and 2.5% of GDP in 2021.

- **Key domestic events and issues to watch:** May Mfg PMI (3 Jun); Apr unemployment rate (4 Jun); May CPI (4 Jun); May services PMI; Apr PPI, retail sales (5 Jun); 1Q final GDP, ECB Governing Council meeting (6 Jun); Apr IP (13 Jun); Apr trade, May CPI; Jun ZEW survey expectations (18 Jun); Apr current account, construction output (19 Jun); Jun prelim PMIs (21 Jun); Jun consumer confidence (27 Jun); Jun CPI estimates (28 Jun).

- **Technical Outlook:** EUR traded a relatively subdued range of 1.1107 – 1.1265 for the month of May. Last seen at 1.1140 levels. Mild bearish momentum on daily chart remains intact while stochastics is near oversold conditions on the weekly chart. Consolidative price action in the past month suggests that an interim double bottom may be forming around 1.1050/1.1100 levels. Technically we are inclined to look for a move higher – buy on dips for a move towards 1.1220 (23.6% fibo retracement of 2019 high to low), 1.1280 (38.2% fibo).

## GBP: Bracing for Change of Leadership and Brexit Process

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **GBPUSD** | **1.2600**<br>(1.3200) | **1.2700**<br>(1.3400) | **1.2700**<br>(1.3600) | **1.2800**<br>(1.3600) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View**: We curbed our enthusiasm on GBP's recovery in the near term as we tamed GBP forecasts lower over the forecast horizon to price in renewed political uncertainties in UK. Questions remain over **who PM May's successor will be**, **if a fresh GE may be held soon**, if **Brexit date (of 31 Oct 2019) will be delayed again** and **how the brexit process (hard brexit or soft brexit bias) could change** going forward. Our GBP forecast is premised on the base case that calls for a smooth exit (i.e. UK to leave EU with a modified deal by 31st Oct though there is chance of another brexit extension). We do caution the GBP could: (1) more than undershoot our forecasts if a General Election is held before Halloween or a case of disorderly exit takes place (i.e. brexit with no deal or hard brexit) or (2) more than overshoot our forecast if brexit is interpreted to be "market friendly" (characterized by smooth exit with a modified deal of possibly exiting earlier than expected). Recovery in investments and growth could come as businesses get more visibility on the road ahead. In this scenario the BoE may need to bring forward its policy normalisation plans. Taken together, GBP could recover more meaningfully via the market sentiment and investor confidence channels (first order effects).

- **Change in Leadership, Brexit Process.** As PM May prepares for her exit on 7th Jun, question remains who her successor is and how the brexit process/stance may change. Former Foreign secretary Boris Johnson has indicated his intent. He said he does not want a no-deal exit but the country must prepare for a no-deal scenario. He hinted that he will go back to EU to re-negotiate some of the most contentious parts of the deal (likely to be the Irish backstop). Dominic Raab, Andrea Leadsom of the Conservative party could possibly contend for the Conservative party leadership.
  - The week starting 10th Jun will see nominations for leadership candidates close and the party's 313 MPs will vote for their preferred candidate and the process will continue until 2 candidates are left remaining before being put through questions and then a final decision will be put to another vote by Conservative party members (124,000 of them). By end-July, a new leader and PM will be announced.
  - That said, Labour Party leader Jeremy Corbyn said that the new leader of the Conservative party should then call for a General Elections at some stage later this year.
  - To complicate the political road ahead, Nigel Farage's Brexit party is projected to win the most UK seats in the European parliament elections. Based on preliminary count (as of 27 May), Brexit party has garnered 31.6% of votes, much more than Conservative (in 5th place with 9.1% votes) and Labour (in 3rd place with 14% votes). Surprisingly, the brexit party is leading with liberal democrat in second place (with 20% votes) and the Greens in 4th place (with 12% votes). These 3 parties already made up more than 60% of the votes, handing the mainstream parties (Conservative and Labour) a crushing defeat (only 23% votes collectively).
- So the big uncertainty remains if mainstream parties will lose out if a General Election is held. That could possibly inject another dose of political uncertainty to GBP - probably a risk at a later stage but is worth keeping a look out for. To add there are plenty of risks out there such as (1) the potential of Scottish independence referendum; (2) another delay on brexit date; (3) and how EU-UK negotiation process may change.
- Despite lowering our forecasts, our upward trajectory remains intact. Based on our model estimates which take into account current account differentials, interest rate differentials and inflation differentials, GBP's fair value estimate fall in the range of 1.42 – 1.46. The -10% deviation (spot to fair value estimate) largely reflects the Brexit premium and 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 hold to our belief that UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term). In the last episode where UK left the ERM back in 1992, GBP saw a period of consolidation (for a few years) at historical lows 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: UK economic growth picked up pace in 1Q to +0.5% q/q** (vs. +0.2% in 4Q). The manufacturing sector grew at its fastest pace (+2.2%) since 1988, possibly due to manufacturers rushing to deliver orders before the initial brexit date of 29th Mar while the surge in imports (of cars and gold) drove the deficit in net trade for 1Q. Service and construction sectors also contributed to 1Q growth, though momentum eased off in Mar. We caution this GDP surge could fade in 2Q as stockpiling efforts may wear off and brexit fatigue could weigh on consumer spending and investments. Nonetheless taking stock, industrial and manufacturing production continued to beat estimates while unemployment rate fell to lowest level (3.8% in Mar) since 1974. Though retail sales slipped in Apr, data continued to beat estimates as textile, clothing and footwear led gains. Services and construction PMIs rebounded from contractionary to expansionary territories for Apr at 50.4, 50.5 respectively (vs. 48.9, 49.7 previously) while manufacturing PMI slipped to 53.1 (vs. 55.1 in Mar).

- **The Quarterly Inflation Report (QIR) on 2nd May shows that MPC central projection looks for UK growth to start picking up next year and rise to over 2% by end of forecast period (2Q 2021).** Business investment is expected to recover and household spending continues to support demand growth. CPI is expected to the slightly below MPC's 2% target for 1H of the forecast period reflecting lower retail energy prices and expect CPI to pick up to above 2% target in 2 years' time as excess demand emerges. This projection is built on the assumption that global growth stabilizes around its potential rate and brexit uncertainties subside gradually. BoE added that economic outlook will depend significantly on the nature and timing of brexit - whether the transition is smooth or abrupt and how financial markets, businesses and household respond. BoE Governor Carney added that business investment is likely to fall for a little while longer; "Gradual and limited" rate hike rhetoric was reiterated but Carney also said that investors were underestimating how much interest rates could rise.

- **UK headline CPI rose to 2% y/y in Apr (up from 1.8% in Mar).** Electricity and gas prices were the main drivers as energy regulator raised price cap on energy providers by 10% in Apr. This is likely to be a temporary effect on headline CPI. Core inflation held steady at 1.8% for a third consecutive month in a row.

- **Monetary Policy Forecast:** We expect BoE MPC to keep policy rate and size of BoE balance sheet unchanged at 0.75%, GBP 435bn, respectively at the upcoming meeting on 20th Jun. Steady CPI (no run-away pressure from BoE's MPC 2% target) and Brexit uncertainty leaves room for BoE to keep policy stance status quo. Maintaining accommodative monetary conditions is what the BoE can do to help support growth amid ongoing Brexit uncertainties. BOE had earlier cautioned for the possibility of further cliff-edge uncertainties that could have significant effect on spending. We **expect BoE MPC to keep policy stance status quo for as long as until end-2019** as **uncertainty over Brexit takes precedence over policy normalisation.** BoE's forward guidance shows another 1 hikes expected to mid-2022. This is roughly in line with markets pricing (via 90D sterling futures) of 1 hike of 25bps at the Jun-2022 MPC meeting (much later than previously priced at Jun-2020. We remain watchful of inflationary pressures as tight labor market is capable of generating domestic price pressures while a case of no-deal brexit could result in sharp depreciation on GBP (brings about higher imported prices and this translates into higher CPI). Sustained rebound in CPI towards 3% again could pressure BoE to hike earlier reluctantly.

- **External Balance Outlook** UK's current account deficit widened to 4.4% of GDP for 4Q-2018. This was the largest deficit since 3Q 2016 owing to trade in good deficit widening. For 2018, current account deficit widened to 3.9% of GDP, from 3.3% in 2017.

- **Key domestic events and issues to watch:** May Mfg PMI (3 Jun); May construction PMI (4 Jun); May services PMI (5 Jun); May house prices, PM May last day of service as Prime Minister (7 Jun); Apr IP, construction output, trade (10 Jun); Apr labor market report (11 Jun); May CPI, PPI, RPI (19 Jun); May retail sales, BoE MPC (20 Jun); 1Q current account balance, Jun GfK consumer confidence (28 Jun).

- **Technical Outlook:** GBP fell sharply for the month of May. Last seen at 1.2615 levels. A death cross was formed (50 DMA cuts 200 DMA to the downside). Area of support at 1.2590 – 1.2610. A break below this support could open room for further downside towards 1.2440 (2019 low). But given stochastics at oversold conditions and bearish momentum is gradually fading. We do not rule out a reversal move higher. Resistance at 1.2660, 1.28 levels (61.8% fibo retracement of 2019 low to high).

## AUD: Without a US-China Trade Deal, Upside Limited

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| AUDUSD | 0.68<br>(0.73) | 0.68<br>(0.74) | 0.69<br>(0.73) | 0.70<br>(0.72) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** There is no deal in sight between the US and China. Missing that, our positive AUD story cannot hold. According to the futures implied rate, more than two rate cuts have been priced into rates for the year and to some extent, in the AUD as we write. The Australian economy remains ever entwined with that of China and the slowdown of the latter last year due to deleveraging efforts in the previous years along with China's capital control and tightened credit access last year have dampened the investors' appetite for Australian's real estate and cause a multi-month slump in the sector.

- The labour market does not seem to have reflected this yet, buoyed by infrastructure spending and wage growth remains mild but positive. The jobless rate rose to 5.2% in Apr from 5.0% previously as the rise in labour force participation is more than the increase in hires that month. Nonetheless, the tick higher has given RBA the reason to consider easing monetary policy. We had looked for a trade deal between the US and China within the quarter to give international trade the recovery from US-China Trade War Version 2018 but that did not seem likely to materialize so soon. With the two mega nations not talking, a "Grey Swan" scenario seems to be increasingly likely. President Xi rallied for a "New Long March" in Jiangxi earlier this month and that is hugely symbolic as the Long March by the Communist Party that gave rise to Mao Zedong as the Party Leader was started in Jiangxi in 1934, under hot pursuit by then Nationalist Chang Kai Shek. The Communist Party eventually survived the Long March in 1935. The New Long March suggests that President Xi is rallying for people to embrace some pain for a longer term victory. As such, we too join the band wagon that the rate cut to 1.00% is more likely than not as the US-China trade tensions become more protracted than expected. However, room for further weakness in the AUD could be limited as the rate cuts have been priced to a considerable extent.

- On the election front, with a fiscal surplus projected by PM Scott Morrison of $7.1bn for the fiscal year through 2020, we had mentioned that there is room for policy maneuvers even if Labour Party takes over the government. And just as we do not expect much downside from a change of government, the gains from the surprise win by Scott Morrison were soon wiped out when RBA's Lowe expressed intention to cut rates in Jun. Morrison has retained most of his team close to him with Josh Frydenberg as Treasurer and Marise Payne in Foreign Affairs. While the government has formed the National Foundation for Australia-China Relations, it remains to be seen if there could be a positive turn in the diplomatic relation with China. Scott's victory was not taken positively by China's press. Global Times stated that the victory of the ruling coalition could mean that China-Australia relations will still face "uncertain prospects". Chinese inflows into Australia plunged to just A$4.8bn in 2018 from A$15.8bn in 2016. Warmer ties would be positive AUD but the existence of the US-China tech and trade war could be a huge hurdle for PM Morrison to repair its relation with China and that in turn could keep AUD depressed.

- **Growth and Inflation Outlook:** The AiG Performance of Manufacturing Index rose to 54.8 from 51.0, a positive leading indicator for the AUD. However, that stands in contrast with the CBA Australia PMI mfg index which deteriorated to 50.9 from previous 52.0. Building approval was dismal, making another steep decline of -15.5%m/m from 19.1%. Year-on-year, building approvals fell -27.3% vs, previous -12.3%. Home loans, investment lending and owner-occupier loan value for Mar also surprised to the downside. AiG Perf of Construction Index for Apr came in lower at 42.6 vs. previous 45.6. Those numbers did not bode well for the housing industry and added pressure on the AUD. APRA has started to loosen lending rules that can allow home-buyers to get a bigger loan. APRA eased lending restrictions by allowing lenders to review and set their own interest floor instead of the current 7%. Along with the rate cuts coming, that could boost housing sector.

- Retail sales (s.adj) accelerated to 3.5%y/y in Mar from previous 3.2%, buoyed by rebound in household good retailing, clothing, footwear and personal accessory and cafes, restaurants and takeaway food services subcomponent. Retail sales ex inflation however, fell -0.1%q/q for 1Q, suggesting that consumption trend is still down, possibly weighed by the negative wealth effect from the slump in housing sector.

- Hopes of green shoots out of China were crushed with the release of the Apr numbers where most indicators of activity in terms of industrial production, retail sales and FAI surprised to the downside. The escalation in trade tensions with the US did not help in the least and left AUD below the 0.69-figure at some point. There are renewed expectations for more infrastructure spending, more targeted RRR cuts and generally fiscal support for the Chinese economy. The iron ore price has surged recently due to a combination of supply disruption from Brazil and rise in demand in China for its steel production. While iron ore and AUD had decoupled in terms of correlation, rise in demand for Australia's iron ore exports could provide the AUD some support on dips.

- **Monetary Policy Forecast:** A rate cut in June is almost fully priced according to the OIS interpolation and eyes are on the language of the RBA statement that would accompany the decision next week. Latest data indicates that the housing sector has not stabilized yet and the dimming prospect of a near-term trade deal would mean that RBA would need to ease soon to insure against further deterioration in the employment and consumption. With the trade war becoming increasingly protracted, two rate cuts from the RBA from 1.5% to 1.0% seem likely. However, futures implied also suggest that more than 50bps reduction is already in the price.

- While the trade war, cautious sentiment and monetary easing is likely to keep the AUD on the backfoot, we should also note that much of the easing bias could be priced. That said, there are not many reasons to be positive on the AUD at this point either which could leave the AUDUSD pair to trade within the 0.68-6.72 range in the month ahead.

- **Latest External Balance Outlook:** Trade balance Mar widened a tad to a surplus of A$4.9 bn vs. previous A$4.8bn.

- **Latest Fiscal Outlook:** Australia's **b**udget deficit shrank to just 0.15% of GDP in 2018 from a peak of 4.1% in 2009. Treasurer Josh Frydenberg projects a fiscal surplus of $7.1bn for the year through 2020. Post budget, PM Scott Morrison announced a plan to set up an Australian Business Growth Fund that is projected to grow to A$1bn when it matures, aimed at creating 250K new small businesses over the next five years.

- **Key domestic events and issues to watch:** 1Q CAPEX on 30th May; AiG Perf of Mfg Index, CBA PMI Mfg, CoreLogic House Px , ANZ Job Adv on 3rd Jun; 1Q BoP Current Account Balance, retail sales, and RBA Meeting on 4th; AiG Perf of Services, 1Q GDP on 5th Jun; trade data on 6th; AiG Per of Construction for May on 7th; NAB Business Survey for May on 11th; Westpac Consumer Conf on 12th; Labour report for May on 13th; RBA Minutes for June on 18th; CBA PMI for Jun (P) on 21st; Private sector credit for May on 28th;

- **Technical Outlook:** May turned out to be a bearish month for the AUD, as its seasonal behavior had predicted. Last seen around 0.6910. The AUD was particularly weakened by a combination of weak domestic data, RBA rate cut considerations for June as well as US-China trade war. AUDUSD remains rather capped by the 21-dma at 0.6930. The weekly and monthly chart suggests bearish bias for this pair. Daily chart shows momentum has turned bullish. Price action could turn higher at the break of the 0.6930 (21-dma). Tactical retracements higher cannot be ruled out. Next resistance levels at 0.70-figure and the 0.7130. Support at 0.68.

## NZD: Consolidation after Decline; Lower Forecast

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| NZDUSD | **0.6500**<br>(0.6800) | **0.6400**<br>(0.6900) | **0.6400**<br>(0.6800) | **0.6600**<br>(0.6700) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** We revised our forecast for NZD lower over the forecast horizon as our underlying assumptions have changed (vs. the prior months) due to recent market development. Trade tensions between US and China have escalated with war on trade expanding to tech and possibly, currencies and chances of a US-China trade deal within this quarter have receded while RBNZ cut rate by 25bps and could possibly cut rate again later in 2H as the risk of prolonged trade war could further dampen investor sentiment, trade/growth and financial markets. Into 4Q 2019-1Q 2020, we expect NZD weakness to fade and possibly recover. As trade war between US and China continues into 2H, statistics on "casualties of war" relating to growth, corporate earnings, financial market stresses will start to pile up, and these could eventually compel US and China to return to the negotiation table. Progression on talks taking both sides closer to a deal into the turn of the year is not impossible and this could help support sentiment and support our view for NZD to recover.

- RBNZ Governor Orr has shown that he somewhat favours a softer NZD and an easing bias. And RBNZ does not want to stand out in the face of most DM central banks including Fed and ECB turning dovish. What could trigger RBNZ to cut rate again would be a more-dovish than expected RBA in Jun MPC meeting and this would add to NZD downside. We do expect some agreement between US and China on a trade deal into end year/ early next year and this could help to support sentiment and possibly a recovery in global growth and the NZD going into the turn of the year.

- Near term (<2 weeks), we do see some technical signs of bullish reversal. Question remains how sustainable the bounce can last. We do not rule out a near term move higher towards 0.6580 (21 DMA), 0.6660 levels. Interim support seen at 0.6480/90 levels (upward sloping trend-line support from the lows of 2015 and 2018. Given a potential "grey swan" environment and NZD has corrected lower (>6% YTD) to 7-month lows, we do not rule out consolidative moves in the range of 0.64 – 0.6750 in the month ahead.

- **2-Way Risks to our Outlook:** Upside boost to NZD is possible if US and China deliver a surprise trade deal at the upcoming G20 Summit in Osaka (28 – 29 Jun). Risk asset including equities, soft/hard commodities could enjoy a lift while currencies including NZD (+1.08x beta with CNH) could strengthen. But in the worst case scenario - there is no deal and trade war turns full-blown with more tariff and non-tariff actions and countermeasures implemented. NZD would have more downside to go in this scenario which is currently not built into our baseline forecast.

- **Growth and Inflation Outlook:** In the recent MPS (released on 8th May), RBNZ cut economic growth forecast to 2.2% in the year through Mar-2019 (vs. 2.9% previously). RBNZ said that growth slowed sharply over 2H 2018 reflecting a moderating global growth and slower growth in domestic demand and the 1H 2019 growth is expected to remain subdued as slowing global growth, subdued housing market and low business sentiment are dampening domestic activity. Slowdown is also expected to see slight softening in labour market over 2019. Increased monetary stimulus and improvement in terms of trade are expected to drive a re-acceleration in growth and capacity pressure from late-2019 as RBNZ looks for growth to rebound to 3.2% in 2020.

- The outlook of domestic inflationary pressure has softened due to slowdown in growth. Non-tradables inflation is expected to ease before gradually picking up in as capacity pressure build. RBNZ only sees a return to 2% mid-point of its target range in mid-2021. This is 6 months later than its previous projection.

- **1Q GDP is scheduled for released on 20th Jun.** Economic data released over the past few weeks remain mixed as 1Q retail sales surprised to the upside and Mfg PMI rose (53.0 in Apr vs. 52 in Mar) but services PMI expanded at its slowest pace (51.8 in Apr vs. 52.3 in Mar) since Sep-2012. Apr exports surged to its second highest on record (NZ$5.55bn), thanks to dairy exports and China's demand for beef and lamb. Labor market painted a dimmed outlook as hiring unexpectedly fell (-0.2% q/q) in 1Q for the first time since 2015 while wage growth came in at a slower pace. 4Q GDP picked up pace to +0.6% q/q (vs. 0.3% in 3Q). 9 out of 11 service sectors including retail, accommodation, transport, warehousing expanded as well as investment rebounded, thanks to business spending and homebuilding. Primary industries and goods-producing industries in manufacturing and utilities were the main drags.

- 1Q PPI fell (output -0.5%; input -0.9% q/q) for the first time since 1Q 2016. This was due to high base effects fir electricity generation prices. Headline CPI held steady at +0.1% q/q in 1Q. On annual basis, 1Q CPI declined to +1.5% y/y, from 1.9% in 4Q. Softer oil prices dragged down tradable inflation while non-tradable inflation (proxy for domestic price pressures) rose +1.1% q/q, up from +0.7% q/q. Going forward, the next print in CPI is likely to show a higher print given the oil prices have risen while NZD depreciated. Taken together, we see risks mildly skewed to the upside for headline inflation.

- **Monetary Policy Forecast:** We expect RBNZ to keep policy rate on hold at 1.5% at the upcoming meeting on 26th Jun, after cutting policy rate by 25bps at the last MPC meeting. We were earlier looking for no cut in May as we do not see any urgency for RBNZ to deliver an "insurance cut" so soon as CPI continues to rise towards the middle of RBNZ target range of 1% - 3% as capacity builds and the risk of further upward pressure on domestic prices, wage growth, etc. We believe those views still justify our call for RBNZ to keep OCR on hold. The risk for another cut could come if economic data surprisingly softens or if RBA cuts policy rate more aggressively (by 50bps) than expected at the upcoming Jun meeting. With markets currently pricing in 60% chance of another cut in the July RBNZ MPC meeting, this probability could creep higher if RBA delivers a dovish cut and this could further weigh on NZD.

- At the last MPC meeting (8th May), RBNZ delivered a 25bps rate cut to take OCR down to 1.5%. MPC judged that a lower OCR is necessary to support the outlook for employment and inflation with its policy target. RBNZ noted that while employment is near its maximum sustainable level, the outlook for employment growth is more subdued and capacity pressure is expected to ease slightly this year. As such inflationary pressures are projected to rise slowly. Governor Orr stopped short of guiding expectations for another cut as he said that it is too early to tell if another cut is needed.

- **External Balance Outlook:** NZ current account deficit further widened to -3.7% of GDP in 4Q from -3.6% of GDP in 3Q 2018. This was due to goods deficit widening while services surplus narrows. This is the widest current account deficit since 3Q 2013.

- **Key domestic events and issues to watch:** 1Q terms of trade (4 Jun): May commodity prices (6 Jun); 1Q manufacturing activity (11 Jun); Apr net migration (12 Jun); May card spending (12 Jun); May Mfg PMI, food prices (14 Jun); May services PMI, 2Q consumer confidence (17 Jun); 1Q current account (19 Jun); 1Q GDP (20 Jun); May trade (25 Jun); RBNZ MPC (26 Jun); Jun Business confidence (27 Jun); Jun consumer confidence (28 Jun).

- **Technical Outlook:** Rebound in NZD was short-lived as NZD traded broadly lower for the month of May. Pair was last seen at 0.6520 levels. Daily momentum turned mild bullish while stochastics is rising. A technical rebound in not ruled out. Resistance at 0.6550 (21 DMA), 0.6650 (50 DMA). Support at 0.6480 (upward sloping trend-line support from the lows in 2015, 2018 and 2019) likely to hold.

## JPY: Beneficiary of Trade War and Growth Slowdown

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDJPY** | 109<br>(108) | 108<br>(106) | 108.50<br>(107) | 110<br>(105) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** We calibrated our FX forecasts given recent market development. We now expect a mild downward sloping trajectory for USDJPY into 3Q-2019 before projecting USDJPY to gradually creep higher into the turn of the year. The downward sloping trajectory takes into account the (1) recent escalation in US-China trade war possibly resulting in a "grey swan" between US and China and (2) risk of further growth slowdown in Japan owing to weak domestic demand and little in the room for BoJ to ease monetary policies further given its ultra-loose setting. In addition, the government could raise VAT to 10% in Oct-2019. This could further dampen consumption and weigh on Japanese equities and USDJPY. The turn-around trajectory for USDJPY into 4Q takes into account our view that trade tensions do not materialize into a full-blown trade war and we look for both US and China to possibly get closer to a trade deal into the turn of the year. This should help to ease worries of global growth slowdown and support risk appetite (providing the lift for USDJPY).

- In the near term (<4 weeks), risk aversion thematic is likely to continue to dominate sentiment in the coming weeks as US-China trade negotiations stalled and tensions have escalated in the past month with war on trade expanding to technology and to some extent, currencies. Nikkei 225 and USDJPY have both fallen 5.6% and nearly 2%, respectively for the month of May. Receding hopes of US-China trade deal within this quarter weighs on global growth, defers hopes of exports recovery and dampen investor sentiment. The leads to heightened risks of further sell-off in risk assets (equities down while bonds up – classical risk off scenario). As USDJPY is positively correlated with equities and UST-JGB yield differentials, a risk-off scenario makes a compelling case to sell USDJPY on rallies.

- As we inch closer towards G20 Summit in Osaka (28-29 Jun), this pair could see greater volatility ahead as markets look out for any scheduled meeting between President Xi and Trump.
  - A meeting between the 2 Presidents could signal hopes of progress towards a trade deal at some stage and this could see USDJPY shorts unwind as risk off sentiment takes a breather but;
  - In the event there is no meeting between the 2 Presidents, this could further weigh on sentiment and global growth,

exports outlook. This could further drag USDJPY lower and result in an undershoot of our end 2Q forecast.

- We reiterate our caution that USDJPY could move lower towards Jul-Oct on political risk factors and potential implementation of sales tax hike in Oct. Both could weigh on risk appetite. There are some concerns over the Upper House elections scheduled in Jul 2019. Dissent expressed through Upper House elections could create some political instability in 2H 2019 and possibly limit the Abe cabinet from pursuing more radical measures to transform the economy. This uncertainty could in turn lead to a sell-off in Japanese equities and the unwinding of hedges, supportive of the JPY. Implementation of the consumption sales tax hike in Oct 2019 and its negative impact on domestic consumption and overall growth could also add downward pressure on the USDJPY in 2H 2019

- **Growth and Inflation Outlook:** 1Q growth surprisingly expanded at its fastest pace in a year at +2.1% q/q SAAR. (vs. 1.6% in 4Q). Positive net exports and increase in government spending offset the softness in private investment and consumption. But concerns remain as strong headline growth masked underlying weakness. Strong net exports was due to sharper decline in imports (-4.6%) while exports also fell (-2.4%). Together with soggy private consumption and investments, these reflects weak domestic demand and is a concern especially in the face of Japan possibly going ahead with VAT increases in Oct (previously delayed twice). Economic Revitalization Minister Toshimitsu Motegi said (20 May) there is no change to the plan to increase VAT to 10% (from 8%) in Oct. Any imposition of VAT could further curb consumption especially when wage growth is not strong. This exposes Japan to a real risk of recession in 2H 2019.

- Headline CPI picked up pace to +0.9% y/y in Apr (vs. +0.5% in Mar) owing to jump in overseas travel cost, accommodation and gasoline prices. Core inflation (CPI ex fresh foods) also ticked higher to +0.9% y/y (vs. 0.8% in Mar). This uptick may well be one-off as inflation could ease as mobile phone charges were cut by more than 40% while free pre-school education will start in Oct. Softer inflationary pressures suggest that BoJ will need to persist with its ultra-loose monetary policy until its 2% inflation target is achieved.

- **Monetary Policy Forecast:** We expect BoJ to keep monetary policy status quo at the upcoming MPC meeting on 20th Jun, with yield curve control at -0.1% for short term rates and 10Y JGB yield at around 0 %; permitted deviation of 10Y JGB yield from target will also be kept at +/-20bps; asset purchase of JGB holdings, ETF and J-REIT will be maintained at JPY80tn, JPY6tn and JPY90tn, respectively. With growth and inflation slowing, ultra-loose monetary policy remains BoJ's choice of policy tool.

- At the last BoJ meeting (25 Apr), the central bank tweaked its forward guidance to make "clearer its policy stance to continue with powerful monetary easing" by vowing to keep extremely lower short- and long-term interest rates at least through spring 2020. Previous forward guidance was "to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time". At the same time, the BOJ also suggested that it could introduce a lending facility for its ETF buying programme, i.e. temporarily lending ETFs to market participants. This would allow for the creation of a market and greater activity for the ETF market that is 77% owned by the central bank.

- **Latest External Balance Outlook:** Current account balance for fiscal year 2018 was down for the first time in 5 years. Surplus was seen at JPY19tn, 12% lower compared to 2017. Decline can largely be attributable to the 84% drop in trade surplus amid trade US-China trade war. For March data, Japan posted a current account surplus of JPY2.85tn. While this is the 57th back to back month of surplus, the latest print was down 10.6% from a year ago.

- **Key domestic events and issues to watch:** 1Q capex, company profits (3 Jun); 1Q final GDP (10 Jun); May PPI, Apr core machine orders (12 Jun); 2Q BSI large mfg (13 Jun); Apr industrial production, capacity utilisation (14 Jun); May trade (19 Jun); BoJ MPC meeting (20 Jun); May CPI (21 Jun); May PPI services (25 Jun); May retail sales (27 Jun); May jobless rate (28 Jun).

- **Technical Outlook:** Our call for USDJPY to head lower (as highlighted in the last monthly FX outlook) more than met our objectives at 110.3 for the month of May. 108.76 low was traded (31 May). Last seen at 108.80 levels. Bearish momentum on weekly chart remains intact while stochastics is falling. 50 DMA looks on track to cut 100 DMA to the downside. Stay short USDJPY and add on rallies remains the game plan. Resistance at 109.90 (21 DMA), 110.60 (100 DMA). Support at 108.60, 107.50.

## RMB: Weakness First

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDCNY** | 6.98 (6.70) | 6.98 (6.75) | 6.95 (6.70) | 6.92 (6.68) |
| **USDCNH** | 6.98 (6.70) | 6.98 (6.65) | 6.95 (6.70) | 6.92 (6.68) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** As the RMB becomes more market-driven, it tends to behave like what most currencies would in times of stress – frontloading of weakness before some recovery as market rationalizes. Periods of overshooting happen often but that does not mean that more risk cannot be priced. The "Sell-in-May" adage was clearly realized in 2019 – triggered at first by Donald Trump's tweet about raising the tariffs for the U$200bn of Chinese exports to the US that were already subject to 10% of tariff, expressing disappointment in the pace of the negotiations. The escalation thereafter officially took place as US raises the tariff rate on Chinese goods, and then on the technological front with Huawei back in the limelight.

- On 15th May, Trump signed an executive order to ban transactions that involves information and communications technology or services designed, developed, manufactured, or supplied, by persons owned by, controlled by, or subject to the jurisdiction or direction of a foreign adversary. On the basis of national security with respect to the threats against information and communication and services, the executive order prohibits transactions with foreign adversaries that pose unacceptable risk to the national security. Two days later, the US Commerce Department placed Huawei and its 70 affiliates on its "Entity List" that would restrict these companies to buy parts and components from US technology. This would mean that Huawei will need a US government license to buy American technology. Thereafter, the US Commerce Department seems to soften its stance by granting a "90days temporary license" to authorize transactions with Huawei effective from 20 May through 19 Aug. This will allow operations to continue for existing Huawei mobile phone users and rural broadband networks. In response, China's state media lamented that further talks would be meaningless if the US does not make any new moves that truly show sincerity.

- China's retaliatory response to tariffs is to raise tariffs to 25%, 20% and 10% on U$60bn of US goods in trade war escalation with effect on 1 June. Tariffs on the US goods will be imposed at 25% on 2,493 items. 20% on 1,078 items, 10% on 974 items and 5% on 595 items. The Finance Ministry released a statement on 28th May stating that a meeting on tariff exemptions was held as China had invited companies to apply for exemptions. Then, there are talks of China restricting its rare earth minerals to the US as the next step of escalation. However, we see a high bar for China to take that step given the fact that US a

- Then came President Xi's rally for a "New Long March" in Jiangxi on 21st May and that is hugely symbolic as the "Long March" by the Communist Party that gave rise to Mao Zedong as the Party Leader was started in Jiangxi in 1934, under hot pursuit by then Nationalist Leader Chang Kai Shek. The Communist Party eventually survived the Long March in 1935. The New Long March suggests that President Xi is rallying for people to embrace some pain for an eventual victorious ending. In addition, that was also a visit to the rare earth mining base after which Beijing declared that it is preparedto restrict shipments of rare earths to the US if necessary.

- With both countries not scheduling any more negotiation visits at this point, it is clear that the talks between the US and China have stalled and a near-term deal is becoming less likely. USDCNH sprung higher above the 6.90-figure. The USDCNH has since stabilized under the 6.95-figure after CBRIC Chief Guo Shuqing warned against shorting the CNY that could result in "huge losses". PBoC Yi Gang was also cited expressing confidence of yuan's stability, taking comfort in the yield spread between the US and China's 10y sovereign bonds. We now change our base case to one of a "Grey Swan" scenario that includes China's upcoming retaliatory tariff to take effect on 1st June as announced but no further tariff-related escalation from both nations thereafter. We revised our 2Q USDCNY forecasts higher to 6.98, taking into consideration our new assumptions and not even ruling out the break of the key psychological 7. However, bear in mind that depreciation of the RMB is likely to be restrained by the PBoC. We expect China to roll out more stimulus with more targeted RRR cuts likely. In this scenario of weakening growth and trade tension with the US, CNY will still be on a weakening bias even though some retracement could be possible into a potential meeting at the G20 Summit in Osaka on 28-29th Jun. Into the turn of this year, we anticipate that further deterioration in global trade, investment and consumption decline as well as financial markets correction may eventually compel both sides to return to the negotiation table that could be interpreted positively by the markets and bring the USDCNY lower towards the 6.92-figure.

- The 12M forward points for USDCNH were normalizing, last seen around 676pips albeit lower from its high of 1135pips at one point, earlier in May. The moves lower was in spite of the non-tariff escalation and could be due to the presence of the countercyclical adjustment factor as well as issuance of yuan bills in Hong Kong that has increased the cost of betting against the CNH. This suggests that even though the yuan is likely to remain on a weakening bias, the move towards 7 could still be slow.

- **Growth and inflation outlook:** The PMI-mfg print for Apr, at 50.1 vs. previous 50.5, that came on the last day of last month was foreboding for activity data. Caixin mfg PMI was also weaker at 50.2 vs. previous 50.8. Industrial production dropped to 5.4%y/y from previous at 8.5%. That was way worse than consensus looking for a growth of 6.5% for Apr. Year-to-date, industrial production slowed from 6.5%y/y seen in Jan-Mar to 6.2%y/y between Jan-Apr. Retail sales also weakened to 7.2%y/y from previous 8.4% and fixed asset for urban came off unexpectedly to 6.1%y/y from 6.3%. This latest data lifts expectations of further monetary policy easing.

- Inflation firmed to 2.5%y/y for Apr from 2.3% previously while PPI rose to 0.9%y/y' as food inflation continued to be buoyed by the rise in the price of pork in the meat and poultry subcomponent, up from +4.7%y/y to +10.1%. prices of eggs also bounced this month along with the price of fresh fruits and vegetables. With inflation still within the target of 3%, we do not think that would stop PBoC from rolling out more targeted RRR cut.

- **Monetary Policy Forecast:** The return of trade tensions between the US and China and assault on China's Huawei could mean that the tariffs could be here to stay for a while, or at least for a few more months. That could continue to affect consumption and investment decisions and activity momentum.

- There were a few mentions of the monetary policy at the NPC including some explicit mentions of more targeted RRR cuts for small and medium enterprises and these could take effect within the quarter to insure against further downside pressure faced by private companies as higher tariffs are imposed on their shipment to the US. More targeted medium term lending facility could also be utilized to improve access to credit for SMEs. We anticipate that a next significant move would be for PBoC to lower the 1y lending rate for the TMLF from the current 3.15% as most of the exporters affected by the tariffs are SMEs. Insofar, the 7 day repo rates have remained stable at 2.8%, in line with what PBoC likes to term as a prudent stance and the central bank may want to keep money market rates stable, that could somewhat serve as an anchor to the RMB. The central bank had stated in its quarterly monetary policy report that was released on 17th May that PBoC stands ready with targeted stimulus at home and to keep the currency stable. Even so, the central bank does not want to let up on the efforts to deleverage the economy. In addition, Premier Li Keqiang has mentioned about tax cuts and fee cuts to support local businesses.

- The recent growth prints and PMI-mfg print could mean that the next targeted RRR cut could happen within the quarter instead of 3Q. We had also caveat our base case (in the last monthly) with a mention that a failure to reach a deal between the US and China that includes the removal of US tariffs on China's goods could mean that this targeted RRR cut could be earlier within this quarter. However, expect 7 day repo to remain largely stable within 2-3%.

- **Latest Fiscal and External Balance Outlook**: China had raised its fiscal target from 2.6% of GDP to 2.8% of GDP in 2019. Focus is on infrastructure spending as well as tax cuts in order to ensure economic and social stability. This is also to ensure that China avoids the "flood-style stimulus" that had resulted in the surge in corporate debt since 2019.

- **Key domestic events and issues to watch:** China's tariff on US exports to China to kick in on 1st June. US may levy tariffs on the rest of untaxed Chinese exports to the US around 10th May (Trump was still undecided); Caixin PMI-mfg for May on 3rd; Foreign Reserves for May on the 7th; money supply, aggregate financing and new yuan loans on 9-15th; trade data on 10th; CPI and PPI on the 12th; May urban FAI, industrial production and retail sales, Jan-Mar property investment due on 14th; new home prices on 18th; FX Net settlement on 20th; industrial profits on 27th.

- **Technical Analyst:** USDCNH surged higher towards the 6.95-figure before stabilizing within the 6.90-6.95 range. The retracement lower left momentum indicators with little directional bias. This comes especially after much jawboning by top officials in China, strong presence of the countercyclical adjustment factor as well as the issuance of the new yuan bills in Hong Kong that makes selling CNH much expensive against the USD. With weakness frontloaded, momentum stemmed, USDCNH may remain within the 6.88-7.00 range.

## KRW: Clobbered by Trade War

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| USDKRW | 1195<br>(1130) | 1195<br>(1135) | 1185<br>(1140) | 1170<br>(1130) |

*Previous Forecasts in Parenthesis*

- **Motivations for the FX View:** We revised USDKRW forecast broadly higher to price in recent escalation in trade war possibly resulting in a "grey swan" between US and China. Receding hopes of US-China trade deal within this quarter dampens global growth, trade outlook and defer hopes of recovery in semi-conductor sector. Risk assets including KOSPI and KRW could retain its bearish bias in the interim. In particular, with war on trade spreading to technology, trade and tech-linked AXJs including KRW and TWD could remain on the back foot. As trade war between US and China continues into 2H, statistics on "casualties of war" relating to growth, corporate earnings, financial market stresses will start to pile up, and these could eventually compel US and China to return to the negotiation table. Progression on talks taking both sides closer to a deal into the turn of the year is not impossible and this could help support sentiment. This forms the basis for our USDKRW trajectory to taper off for 4Q 2019 into 1Q 2020.

- In the near term, there are however mitigating factors at play that could see KRW enjoy some breather in the near term after comments from regulators in Korea warned that KRW was falling too rapidly in short period. Such comments typically raise caution over potential efforts undertaken by authorities to smooth excess volatilities. China regulator Gao Shuqing also warned against shorting RMB. This has also helped RMB and other AXJ FX including KRW to recover slightly. Meanwhile recent US proposal (24 May) to impose tariff on imports coming from countries with undervalued FX may also deter Asian FX from depreciating too quickly for fear of being subjected to tariff imposition.

    - US' recent proposal for tariffs on goods coming from nations with undervalued FX would let US companies seek anti-subsidy tariffs on products coming from countries identified by US Treasury Department to be engaging in competitive devaluation. While no countries are found to meet the criteria, it also sets a broader standard by focusing on the "undervaluation" of FX in a 2-step benefits analysis in determining the country's REER and equilibrium REER as well as its nominal and actual bilateral FX. The difference of the nominal and actual average nominal bilateral exchange rate could demonstrate the existence of a "benefit" from currency appreciation.

- While bias for USDKRW remains supported on dips, we highlight that any surprise trade deal or conciliatory tone at the upcoming G20

Summit in Osaka (28 – 29 Jun) could see an unwinding of USDKRW longs as a deal would lift sentiment and spur a pick-up in business, investment and exports activity and this could support growth. The semi-conductor down-cycle could also turn around and lend support to exports and investment recovery. And we expect USDKRW upward pressure to fade when the above-mentioned factors come into play. We believe chance for trade deal and for the above to possibly come into play at some stage at the turn of the year.

- **Growth and Inflation Outlook: Korean Development Institute (state-run think-tank) downgraded 2019 growth and inflation forecast to 2.4%** (vs. 2.6% in its last projection) and 0.7%, respectively. The downward revision was due to headwinds from US-China trade dispute with a slowdown in China dragging Korea's export-dependent economy (KR exports 25% of its exports to China). Note that KDI's forecasts are more bearish than BoK and the government's growth forecast of 2.5% and 2.6 – 2.7%, respectively. BoK's rationale for the downside in 2019 growth was due to weakening exports in particular semiconductors and slowing business investments. Governor Lee noted that uncertainties have grown over the prospects of trade talks between US and China, but he did not sound overly panic in saying "we need to calmly watch as there are considerable expectations that the 2 countries will continue efforts to strike a deal" (10th May). Recall that in late Apr, Governor Lee said that concerns over recessions were "excessive" and the economy is still expected to grow roughly in line with its potential rate. He added that exports and capital spending should improve in 2H 2019. **BOK also lowered 2019 inflation outlook for a second time this year to 1.1% y/y (down from 1.4% y/y previously).**

- **South Korea's economy contracted in 1Q (-0.3% q/q vs. +1% in 4Q).** This is the largest magnitude of decline in 10 years. Contraction was led by facilities, construction investment as well as exports. On y/y terms, 1Q GDP growth expanded 1.8% in 1Q (vs. 3.1% in 4Q). According to preliminary data, 20-days exports fell 11.7% in May, following a 8.7% decline in Apr. Semi-conductor exports (1/5 of Korea's exports) declined further to 33% (vs. 25% in Apr). Exports to China fell 15.9%. Hopes for a recovery in the tech down-cycle in 2H could come later after US-China trade tensions escalated in the past month.

- **Headline inflation picked up pace to 0.6% y/y in Apr** (vs. 0.4% in Mar) owing to the increase in prices for agricultural, livestock and fishery products as well as services while prices for industrial goods and oil product prices fell. Core CPI held steady at 0.9% y/y.

- **Monetary Policy Forecast**: We **expect BoK to keep policy rate unchanged at 1.75% at the upcoming MPC meeting on 18 Jul** as BoK adopts a "wait-and-see" approach in the interim to assess the spillover effect of external risks arising out of ongoing US-China trade dispute on its economy. BoK is careful not to send any negative signals to markets as a rate cut could exacerbate household debt problems and trigger capital outflow (amid KRW depreciation). We believe the G20 Summit in Osaka (28 – 29 Jun) could give policymakers some sense on how quick or protracted the trade negotiations could take.

We acknowledge that risks for BoK to cut policy rate by 25bps could rise if policymakers see a delay (rather than sooner) in US-China trade deal given slowing inflation, surprise contraction in 1Q growth and continued decline in exports amid US-China trade war uncertainty environment.

- **But BoK may prefer to exercise patience** and watch how trade talks develop. The slowdown in growth is not entirely unexpected (though the magnitude may be larger than expected) given semiconductor down-cycle while policymakers have responded with supplementary budget of KRW6.7tn. In addition BoK officials and policymakers remain optimistic of growth turnaround in 2H and believe that semiconductor down-cycle is nearing its end. This was consistent with our call that a potential US-China trade deal in coming quarter could translate into a pick-up in business, investment and exports activity and this could support growth – but hopes of a potential deal in coming quarter may have been dashed for now and we question on the timing of turnaround. Hence we do see some risks that BoK may want to acknowledge that downside risks to growth may have increased and easier policies could be possible (dovish tilt).

- At the last MPC meeting on 31st May, BoK MPC kept policy rate on hold at 1.75%, as widely expected. But the decision was not unanimous. One member Cho Dong-Chul voted for a rate cut. BoK Governor Lee acknowledged facing a "difficult situation" but cautioned against an excessively pessimistic view of the outlook as the central weighs concerns about record high household debt and a rapid decline in the KRW in recent weeks. Cutting rate may trigger capital outflows and that could depress the KRW further and send a wrong signal to markets.

- **External Balance Outlook:** Current account surplus widened to $4.8bn in Mar, from $3.6bn in Feb. On a quarterly basis, 1Q current account surplus hit the lowest level in 27 quarters due to sluggish exports caused by tech down-cycle, US-China trade war concerns. Trade surplus for goods narrowed to its lowest level since 1Q 2014.

- **Key domestic events and issues to watch:** S. Korea releases May exports (1 Jun); May Mfg PMI (3 Jun); 1Q final GDP, May CPI (4 Jun); May FX reserves (5 Jun); Apr current account (5 Jun); May unemployment rate (12 Jun); May export, import price index (14 Jun); May PPI (20 Jun); May IP (28 Jun).

- S. Korea releases Apr exports (1 May); Apr FX reserves (7 May); Apr import, export prices (14 May); Apr unemployment rate (15 May); Apr PPI (21 May); 1Q short term external debt (23 May); May consumer confidence (28 May); Apr industrial production, BoK meeting (31 May).

- **Technical Outlook:** USDKRW traded sharply higher for the month of May. Last seen at 1190 levels. Bullish momentum on weekly chart remains intact though stochastics rose into overbought conditions. Resistance at 1200 (76.6% fibo retracement of 2016 high to 2018 low). Pace of further up-move likely to moderate from current levels. Pullback move lower should find support at 1180, 1172 (61.8% fibo).

## SGD: Victim Of Trade Conflict Escalation

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDSGD** | 1.3850 (1.3400) | 1.3850 (1.3300) | 1.3800 (1.3500) | 1.3750 (1.3600) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** We revised USDSGD forecasts broadly higher to price in the increased dimensions in which the Sino-US trade war expanded in—supply chains, tech, forex policy—with some negative implications for growth in the near-term. Having broken out of the 1.3450 – 1.3650 range that has persisted since the start of the year, the USDSGD is unlikely to see a quick reversion to lower levels previously. As the likelihood of prolonged trade negotiations increases, SGD could continue to retain some bearish bias. Nonetheless, the move up in USDSGD should be capped, as USD itself could see some softening with the easing in US growth momentum. Notably, the SGD NEER has already fallen around 0.5% since end-April, even as it remains modestly above the mid-point of the band. With varying factors pulling on the pair, USDSGD could remain in the 1.371 to 1.387 range in the near-term, until more concrete details of a Sino-US trade deal potentially provide some reprieve towards the end of the year.

- Market sentiments soured following Trump's May 10 announcement of the increase in tariffs (on US$200 billion worth of Chinese goods), and worsened subsequently alongside China's tariff retaliation (on US$60 billion worth of US exports). The top two categories (in value) of Chinese goods affected by the US tariffs were "electrical machinery, sound and tv equipment" as well as "machinery & appliances". Notably, these are goods categories where supply chains span China and many parts of Asia, including Singapore—a 2018 study by MTI reports that nearly 10% of our GDP is attributable to our exports to China (both final and intermediate demand). An AmCham China survey released this month also indicated that up to two-fifths of MNCs in China are considering or have already relocated supply chains outside China, showcasing the potential extent of supply disruption in the region.

- The step-up in the USDCNH 12-month forward in May suggests renewed upside risks to the USDCNH, alongside signs that the trade war is broadening into a "tech war" (e.g., fight for 5G dominance). Thankfully for China, a modest growth easing looks more likely than a sharp hard-landing for now, given the multiple stimulus tools that the Chinese government still has at its disposal, including further automobile tax cuts, RRR cuts or increasing use of targeted medium-term lending facilities (to needy sectors of the economy). PBOC Governor Yi Gang has also reiterated the central bank's commitment to keep the yuan stable. These factors should cap the upsides in USDCNY and correlated proxy currency pairs such as USDSGD.

- Current market participants seem to be expecting a period of drawn-out negotiations between China and US, compared to initial optimism that a conclusive deal could be reached in 2Q. No date has yet been fixed for US Treasury Secretary Mnuchin's visit to Beijing, and he was quoted as saying that there was "still a lot of work to do" before a deal can be reached. With the next meeting between Trump and Xi likely take place at the G20 summit end-June, it is reasonable to expect that negotiations could be drawn-out and (positive) details might even only trickle out in the latter part of the year.

- There could be some volatility in the USDSGD pair in the interim, including USD-led dips, on news of weakening growth coming out of the US. The robust 1Q US growth figure was partly due to rising inventories (one-fifth contribution) and tanking import growth—businesses had front-loaded buying in the second half of 2018 ahead of tariff implementation. Support from these factors is unlikely to persist going forward, and a potential Fed easing bias could lead to some unwinding of long USD positions against its G10 peers and selected AXJs, including the SGD. Nonetheless, without clearer signs that the trade war is ending, a downtrend in USDSGD is unlikely in the near-term.

- **Growth and Inflation Outlook:** MTI highlighted that the global growth outlook for 2019 has weakened since their assessment in February. Taking into account downgrades in (IMF) forecasts for key demand markets for Singapore, greater trade policy uncertainty, as well as the maturing of the global electronics cycle, the official 2019 GDP growth forecast for Singapore has been narrowed downwards to "1.5 to 2.5%" from 1.5 to 3.5%" previously, effectively removing expectations of significant potential growth upsides in the latter half of the year. This is consistent with our Economist's latest GDP forecasts for Singapore at +1.6% and +2.1% in 2019 and 2020 respectively. The likelihood of a manufacturing and trade recovery in 2H 2019 is dim, given the protracted nature of ongoing Sino-US negotiations. Potential disruption to intermediate goods demand from the reconfiguration of regional supply chains, as well as stricter foreign worker measures (DRC cut in services starting Jan 2020) could also pose modest drags on GDP growth into 2020. On the other hand, there are bright spots in ICT, construction, health and education which could impart some resilience to the economy. The labour market also remains broadly healthy—resident unemployment rate is relatively stable at 3.0%, vacancy-to-unemployed ratio is still above 1. On the inflation front, MAS also revised the forecast range for MAS Core Inflation in 2019 downwards to 1-2%, from 1.5-2.5% previously, due to lower global oil price projections, as well as the impact of the liberalisation of the retail electricity market on electricity prices. Our Economist expects core inflation for Singapore to average 1.4% for 2019.

- GDP for 1Q 2019 saw growth come in at its weakest pace since the Global Financial Crisis at +1.2% y/y (vs. revised +1.2% in 4Q 2018) as manufacturing contracted for the first time in three years, dragged lower by the maturing global electronics cycle and disruption from the Sino-US trade war. On a seasonally-adjusted q/q annualised basis, GDP expanded by +3.8% (vs. to -0.8% in 4Q). The bright spot though was modern services (ICT, finance, business services) and construction. Overall services rose +1.5% y/y, on par with outturns in 4Q despite softer activity in trade-related sectors such as wholesale and transport & storage. Construction rebounded, rising +2.9% y/y in 1Q (vs. -1.2% in 4Q) on the back of both public and private sector construction works.

- Headline CPI rose by +0.8% y/y in April (from +0.6% in March) due to a pickup in private road transport costs (Apr: +1.1% y/y vs. Mar: -0.9%), mainly due to higher car prices and a stronger pickup in petrol prices. Core CPI though eased further to +1.3% in April from +1.4% y/y in Mar, underpinned by a fall in the cost of electricity & gas and lower food inflation. Electricity & gas prices fell by 2.8% yoy in April, due to lower electricity tariffs and the dampening effect of the phased nationwide launch of the Open Electricity Market.

- **Monetary Policy Forecast**: After tightening monetary policy at both of its semi-annual policy meeting last year, the MAS affirmed a pause in its policy normalisation process in April as growth eased and inflationary pressures remain mild. Its policy of a "slight appreciation bias" for the SGD NEER was maintained, with the slope of the SGD NEER policy band still assumed at 1.0% (house view). The pause came as the MAS turned more cautious given the uncertainties in the global environment, cautioning in its statement that "significant uncertainty remains over the short-term outlook". This was largely warranted, as trade tensions flared up shortly after in May.

- Our Taylor Rule estimates for the SGD NEER highlight that the SGD NEER should remain on the upward trajectory in 2H given current growth and inflation projections. Given increased downside risks to growth and continued benign inflation, w**e expect the MAS to extend its pause at its next policy meeting in Oct**. Notably, as the SGD NEER is currently estimated to be in the upper half of the band, the width of the band could potentially accommodate some implicit easing if part of the downside risks materialise, even if there is no change to the official policy stance. As at writing, USDSGD is around 1.3790, and trades around 0.65% above the implied mid-point of 1.3882, with the top estimated at 1.3606 and the floor at 1.4158.

- Alongside a higher USDSGD, domestic interest rates have returned to the highs reached earlier in the year. The 3-month SOR (3MSOR) is at 2.04217% at the time of writing, while the 3-month SIBOR (3MSIBOR) is at 2.00702%. Nonetheless, further increases in the 3-month SOR and 3-month SIBOR could be significantly more gradual as the withdrawal of monetary stimulus in the advanced economies slows as well. Deposit rates (for 12-month fixed) remained at around 0.55%. While risks related to interest rate increases could affect financial and economic stability, particularly in interest rate- and property-related sectors, the interest rate easing bias in the US could cap the these risks for now. We expect the 3MSIBOR and 3MSOR to remain flattish at around 2.07% and 1.95% respectively by end-4Q 2019. For 2Q 2019, we are also penciling the 3MSIBOR and 3MSOR to come in at 2.07% and 1.95% respectively.

- **Latest Fiscal and External Balance Outlook:** The FY2019 budget is modestly expansionary, with the primary deficit projected at

SGD5.4bn (1.1% of GDP). Authorities estimate a fiscal impulse of around +0.7%, providing an appropriate boost to the economy given presence of external headwinds. This comes on the back of an increase in projected expenditure of SGD1.3bn to SGD80.3bn, and an increase in operating revenue of SGD1.2bn to SGD74.9bn. The overall deficit is penciled to come in at SGD3.5bn (0.7% of GDP) due to the record-high special transfers of SGD15.3bn in the FY2019 budget (FY2018: SGD9bn).

- Delving into Budget FY2019, we see that various measures were specifically targeted at SMEs, with the intention of providing credible upgrading support to viable enterprises. The Productivity Solutions Grant extension, Automation Support Package and Industry Digital plans will encourage businesses to adopt automation and other tech-solutions to a greater extent in their operations, helping to achieve productivity improvements over the medium term. Concerns of skill gaps in various sectors also pushed the government to initiate Professional Conversion Programmes which will help support entry of mid-career professionals into new growth areas such as blockchain and software development. Co-investment programmes will see the government helping to catalyse private sector funding of SMEs that are ready to scale up. These measures aim to overcome medium-term challenges in capital and labour allocation for the economy, and should further backstop growth going forward.

- The current account (CA) surplus started 2019 on a positive note. The CA surplus widened to SGD20.3bn in 1Q 2019 from SGD18.0bn in 4Q 2018. As a percentage of GDP, the CA surplus rose to 16.4% in 1Q vs. 14.2% in 4Q. The larger CA surplus was due partly to an increase in the goods and services surplus of SGD30.7bn (from 4Q's SGD30.2bn) and the smaller outflow from both the primary (1Q: -SGD8.3bn vs. 4Q: -SGD9.9bn) and secondary (1Q: -SGD2.1bn vs. 4Q: -SGD2.4bn) accounts. Notably, the narrowing of the services deficit helped offset a smaller goods balance from weakening exports.

- **Key domestic events and issues to watch:** May PMI (3 June); Apr Retail Sales (10-17 June); 3Q Manpower Survey (11 June); May Exports (17 June), May CPI (24 June); May IIP (26 June).

- **Technical Outlook:** USDSGD traded sharply higher for the month of May. Last seen at 1.3790. Daily momentum indicates a waning bullish bias, while stochastics shows a tentative easing from overbought conditions. Risks modestly skewed to the upside in the interim. Area of resistance at 1.387 (2018 high). Break above could usher in further upside play towards 1.39-1.40 levels. Support at 1.3770 (76.4% fibo retracement of 2018 high to 2019 low), 1.3710 (61.8% fibo) and 1.3660 (200 DMA).

## MYR: US-Sino Trade & Tech Conflict to Weigh

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| USDMYR | 4.2000<br>(4.0800) | 4.2000<br>(4.0500) | 4.1700<br>(4.1000) | 4.1700<br>(4.1200) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** The MYR reached a high of 4.1963 in May as the US dollar strength gain ground after US-China trade talks stalled and the CNY weakness led to weaker Asian currencies. Our base case is for a protracted series of trade talks heading into year end, with an elevated worst case of an all-out trade war a possibility. We see the possibility of the effects of the trade war coming out strongly by the fourth quarter this year before trade talks resume before year end and thus seeing some respite for CNY and Asian currencies. At the same time, as growth momentum slows and it is being reinforced by economic data releases in 2H, we see regional central banks likely to stay accommodative and regional exports remain under threat for more contraction. All these should keep Asian FX including the MYR softer in 2H 2019. However, any signs of positive news from FTSE Russell in Sep 2019 and possible resumption of US-China trade talks or further investment inflows into Malaysia and MYR-denominated assets could mitigate negativity surrounding the MYR. Taking all the above into consideration, we revise the MYR forecasts to reflect the protracted effect of the trade and tech war concerns likely to weigh on the MYR but with some optimism of a trade deal between US and China possibly coming in end 2019 eventually supporting sentiment and provide the lift for activity and exports, eventual softer USD could help weigh on USDMYR in 4Q 2019.

- MYR can also be supported by Brent crude oil price which may move higher to above $70/bbl. However, we expect oil and palm oil prices to remain range bound in June and should have limited impact on the MYR. Fundamentally, we think the picture for risk assets including EM FX such as MYR remains quite bright if global growth sees some sustained green shoots amid extended easy monetary policy, provided markets and policymakers manage to navigate near-term risk events such as Brexit and US-China trade and tech wars.

- Other factors that could have some mild impact are the effects of the currency manipulation thresholds by the US Treasury and the Proposal of Countervailing Duties by US Department of Commerce coming into effect late 2019. In effect, we think this could mitigate regional currencies weakness, including the MYR in 2H 2019. The Department of Commerce will be collecting comments from the public until June 27, and details of refinements or implementation could potentially be released in 3Qor 4Q, if Trump wishes to turn on the heat for countries that he's entering into trade negotiations with. In the meantime, as a result of the DOC notice, there is a chance that aforementioned countries could be slightly more motivated to smooth excess volatilities in their currencies, to lower the likelihood of being targeted for countervailing duties. Hence we see this latest development as being a new (mild-impact) factor in limiting further upward movements in USD-Asia currency pairs. Nonetheless, if FX-related criticisms or announcements coming out of the US continue to escalate, it could be viewed as a broadening of the dimensions of the current US-Sino trade conflict, which could be more severe in macro impact.

- External reserves recorded back-to-back fortnightly decline as it dropped by –USD0.6b to USD102.8b as at mid-May 2019 (end-Apr 2019: -USD0.1b to USD103.4b), mainly amid net portfolio capital outflows as markets reacted to the re-escalation of US-China trade tension. Foreign investors were net sellers of Malaysian equities so far in May 2019 totaling –MYR1.96b (Apr 2019: -MYR1.4b) as market reacted negatively to re-escalation in US-China trade war following stalled trade talks and the return of “tit-for-tat” tariff actions between US and China that put the prospect of a trade deal in limbo.

- After the net foreign selling of Malaysian bonds in Apr 2019 of –MYR9.8b in reaction to FTSE Russell’s announcement on 16 Apr 2019 of Malaysia being put under “watch list” for potential exclusion from its flagship World Government Bond Index (WGBI) ahead of the index’s constituents review in Sep 2019, our Fixed Income Research expects another month of net selling – albeit smaller - in May 2019.

- Positively, BNM on 16 May 2019 announced several measures to address the “market accessibility” issue raised by FTSE Russell, especially in improving onshore bond and FX market liquidity. This is in line with the regulator’s intention and our expectations of continuously broaden and deepen the onshore financial markets, instead of the speculated lifting of the ban on offshore MYR non-deliverable forwards (NDF).

- Malaysia’s latest external reserves figure of USD102.8b is equivalent to 7.4 months of retained imports and 1.1x total short-term external debt i.e. adequate vis-à-vis the minimum thresholds of 3 months and 1.0x respectively. It is also 9.9% above the estimated minimum required reserves of USD93.5b under IMF’s Assessment of Reserve Adequacy (ARA) framework that essentially looks at the risks of balance of payment crisis and capital flight. Furthermore, the official external reserve is not the only means for private sector - banks and corporations - to meet their external obligations as Malaysia has sizeable external assets outside the official external reserves. As at end-1Q 2019, banks and corporations held MYR1.27tr of Malaysia’s MYR1.7t external assets, which is more than enough to cover their MYR698.6b external debt obligation

- **Growth and Inflation Outlook:** 1Q 2019 real GDP growth slowed to +4.5% YoY (4Q 2018: +4.7% YoY) in line with our +4.4% YoY estimate. Maintain our 2019 growth forecasts of +4.7%, pending clarity on US-China trade situation as the deadline for a deal is next month, and in view of the stimulus to domestic demand following BNM’s 25bps OPR cut and revival of major infrastructure and development spending projects.

- On the supply-side, slower growth were printed in services (1Q 2019: +6.4% YoY; 4Q 2018: +6.9% YoY), manufacturing (1Q 2019: +4.2% YoY; 4Q 2018: +4.7% YoY) and construction (1Q 2019: +0.3% YoY; 4Q 2018: +2.6% YoY) plus contraction in mining (1Q 2019: -2.1% YoY; 4Q 2018: -0.7% YoY) which offset agriculture rebound (1Q 2019: +5.6% YoY; 4Q 2018: -0.1% YoY).

- On the demand-side, domestic demand eased (1Q 2019: +4.4% YoY; 4Q 2018: +5.7% YoY) on slower private sector expenditure (1Q 2019: +5.9% YoY; 4Q 2018: +7.8% YoY) and decline in public sector spending (1Q 2019: -1.4% YoY; 4Q 2018: 0.0% YoY). Trend in private sector expenditure reflects slower private consumption (1Q 2019: +7.6% YoY; 4Q 2018: +8.4% YoY) and private investment (1Q 2019: +0.4% YoY; 4Q 2018: % YoY). Public spending was dragged by the drop in public investment (1Q 2019: - 13.2% YoY; 4Q 2018: -5.9% YoY) as public consumption growth picked up (1Q 2019: +6.3% YoY; 3Q 2018: +4.0% YoY).

- Net external demand growth moderated (1Q 2019: +10.9% YoY; 4Q 2018: +15.5% YoY) as exports of goods and services stagnated (1Q 2019: +0.1% YoY; 4Q 2018: +3.1% YoY) and imports of goods and services shrank (1Q 2019: -1.4% YoY; 4Q 2018: +1.8% YoY).

- Our 2019 growth forecast of +4.7% (2018: +4.7%) is premised among others on the recovery in mining and agriculture sectors and crucially on a US-China trade deal to mitigate the downside risks to global economic and trade growth, thus the export-oriented manufacturing and trade related services sectors.

- In addition, measures to stimulate domestic economy have been rolled out. We estimated BNM's 25bps OPR cut entails MYR1.4b savings on mortgage repayment, equivalent to 0.3ppt and 0.1ppt upsides to private consumption and GDP growth respectively, based on consumer spending multiplier of 1.5x. With construction multiplier of 2.03x being the highest among economic sectors, the revival of major infrastructure projects (e.g. MRT2, LRT3, Pan Borneo Highway, ECRL) and MYR14b worth of Government development spending projects previously put under review is positive to growth.

- The key lookout now is US-China trade "endgame" given current reescalation in trade tension and the deadline for a trade deal next month. We will review our full-year growth forecast in time for our next economic outlook and lookout to be issued end of next month.

- Inflation stays moderate in Apr 2019 as it rose by +0.2% YoY (Mar 2019: +0.2% YoY; YTD 2019: -0.2% YoY) as transport costs continue to post smaller decline. No change to our 2019 inflation forecast at +1.5% (2018: +1.0%) amid factors such as the broadening of Sales Tax and Service Tax (SST) coverage, Budget 2019's new taxes (Soda Tax, Airport Departure Levy), hikes in minimum wage and utility costs, and rising global crude oil prices hence domestic retail fuel prices.

- Meanwhile, core CPI rose +0.5% YoY (Mar 2019: +0.5% YoY; YTD 2019: +0.4% YoY; 2018: +0.8%). While most components in core CPI recorded negative YoY change during the month, FNAB, HWEGOF, education and restaurants & hotels continue to rise YoY during the month.

- No change in our view that 2019 headline inflation to stay benign with gradual pick-up in 2H 2019 to average +1.5% for the year (2018: +1.0%), reflecting factors such as the broadening of the SST base; Budget 2019's new taxes e.g. Sugar Tax (postponed to 1 Jul 2019 from 1 Apr 2019), departure levy for all outbound air passengers (1 June 2019); hikes in minimum wage and utility costs; firmer global crude oil prices and the expected floatation of RON95 & diesel prices in 2H 2019 after the roll out of the targeted and quota-based fuel subsidy for B40 households.

- **Monetary Policy Forecast:** BNM cut the Overnight Policy Rate (OPR) by 25bps to 3.00% at the Monetary Policy Committee (MPC) meeting on 6-7 May 2019, the first change since the 25bps hike in Jan 2018. At this juncture, barring major negative shock(s) on economic outlook, we expect OPR to be unchanged going forward for the rest of the year. In justifying the 25bps OPR cut, BNM continues to highlight that the risk to growth remains on the downside, mainly due to unresolved US-China trade tensions. Consequently, BNM sees global growth moderating going forward. Domestically, 1Q 2019 real GDP growth slowed to +4.5% YoY (4Q 2018: +4.7% YoY). Maintain our 2019 growth forecasts of +4.7%, pending clarity on US-China trade situation, and in view of the stimulus to domestic demand following BNM's 25bps OPR cut and revival of major infrastructure and development spending projects.

- Positively, BNM on 16 May 2019 announced several measures to address the "market accessibility" issue raised by FTSE Russell, especially in improving onshore bond and FX market liquidity. This is in line with the regulator's intention and our expectations of continuously broaden and deepen the onshore financial markets, instead of the speculated lifting of the ban on offshore MYR non-deliverable forwards (NDF). The measures are: (1) Enhance repo market by increasing the availability of off-the-run bonds to be borrowed for market-making activities and repo tenor to be allowed for extension beyond 1 year. The current repo guideline, last updated in July 2015, will be reviewed accordingly. (2) Delivery mechanism of MGS futures will be changed from cash settlement to physical delivery. The current MGS futures market is highly illiquid. Physical delivery with the transfer of securities instead of cash settlement could help increase market activity. (3) Accessibility to onshore dynamic hedging is widened by including trust banks and global custodians who act on behalf of institutional clients. We think this is an important move, as it eases accessibility for some global funds with a preference to execute FX transactions through global custodian. Previously only institutional investors registered with BNM are given access to dynamic hedging. (4) Hedge ratio for selling Ringgit under the dynamic hedging framework is maintained at up to 100%, but the buy Ringgit ratio through forward contracts may go beyond the current 25% cap of underlying assets subject to approval by BNM. This could provide flexibility to manage investors' positioning in Malaysia through FX exposure instead of outright bond purchases. (5) FX transaction and documentation process will be standardised and simplified. It is indicated that a standard documentation guide for FX transactions has been developed by the industry and will be circulated for reference by market participants. (6) Reiteration of the existing Appointed Overseas Office (AOO) framework which is tasked to provide Ringgit liquidity out of the local trading hours for foreign investors.

- **Latest Fiscal and External Balance Outlook:** There was no immediate downgrades in Malaysia's sovereign credit rating and/or rating outlook by the international rating agencies (IRCs) after the tabling of Budget 2019 back on 2 Nov 2018 which saw the resetting of 2018's budget deficit to GDP ratio to -3.7% vs the original target of - 2.8%, followed by -3.5% for 2019.

- In fact, on 7 Dec 2018, Moody's reaffirmed Malaysia's investment-grade sovereign credit rating of "A3" and the "Stable" rating outlook. The rationales for the reaffirmations in credit rating and rating outlook reflect Malaysia's credit profile strengths i.e. (1) Diversified economy and resilient growth; (2) Stable financing conditions and deep domestic capital market arising from large domestic institutional investor base that mitigate risk from sizeable non-resident presence in domestic financial market, especially the foreign holdings of Government bonds i.e. 38.8% of total Malaysian Government Securities (MGS) and 24% of total MGS and Government Investment Issues (GII) as at Nov 2018; (3) Sustained current account surplus; (4) Institutional framework that include sound monetary policy and Government's commitments to improve transparency, accountability, governance as well as checks and balances in the public sector.

- But fiscal situation remains challenging. However, Moody's cautioned that Malaysia's fiscal strength has weakened as fiscal policy flexibility and debt affordability are constrained. Government debt to GDP ratio of 52.8% (including 1MDB debt) and its debt servicing or interest payments of 13.1% of revenues estimated for 2018 are above the medians of 39.7% and 4.7% respectively for Moody's A-rated sovereigns.

- Moody's also highlighted potential catalysts for upgrade and downgrade in rating. Rating upgrade factors include significant increase in scope for and speed of fiscal consolidation (e.g. measures that broaden revenue base). Rating downgrade factors include economic growth shock that adversely affect fiscal conditions via negative impact on revenue and limited scope for expenditure cuts. Moody's also cautioned that rising political tensions and divergences in view within the Government could undermine fiscal policy effectiveness and delivery of other policy pledges like on transparency, governance and corruption.

- Credible measures to broaden tax revenue base are important. Moody's is of the opinion that Budget 2019's tax and non-tax measures like broadening the Services Tax, reviewing property-related tax (RPGT, stamp duty), introducing "minor" new taxes ("Sugar Tax"; airport departure levy) as well as asset monetization (Airport REIT, land sales) are not sufficient and sustainable means to widen the revenue base.

- **To achieve the Medium-Term Fiscal Framework target of lowering budget deficit to GDP ratio over the next 3 years.** Meanwhile, rating reviews of other major international rating agencies (S&P, Fitch) are still pending. And we expect crude oil price to stay volatile, hence our assumption of USD65/bbl average in 2019 against Budget 2019's assumption of USD72/bbl average. These are the posers the Government's mid-term target of steadily lowering budget deficit to GDP ratio from -3.7% in 2018 to -3.5% in 2019, -3.0% in 2020 and -2.8% in 2021 followed by the longer-term aim of around -2.0%. In the interim, PETRONAS strong cash position currently should help the Government to forestall any need to recalibrate Budget 2019 despite the recent fall in crude oil price - unlike what happened to Budget 2016 that had to be recalibrated in Jan 2016 after its tabling in Oct 2015 as crude oil price plunged 60% from USD66/bbl in early-May 2015 to a low of USD26/bbl in Jan 2016, against the Budget 2016's crude oil price assumption of USD48/bbl. Thus a key lookout for 2019 is the Tax Reform Committee's (TRC) recommendations and proposals for tax system reforms and overhaul. The TRC was "operational" in Sep 2018 and is expected to complete its task by mid2019.

- **Key domestic events and issues to watch:** FX reserves (11, 21 June); Industrial Production (11 June); CPI (26 June), Trade Balance (3 June).
- **Technical Outlook:** USDMYR drifted higher for the month of May. Last seen at 4.19 levels. While bullish momentum on weekly chart remains intact, stochastics has risen into overbought conditions. We see some chance that double top at 4.2020 could stall up-move in the interim. Pullback should find support at 4.18, 4.15 levels.

## IDR: External Headwinds Pressure

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| USDIDR | 14500<br>(12900) | 14500<br>(12700) | 14200<br>(12900) | 14200<br>(12900) |

*Previous Forecasts in Parenthesis*

- **Motivation for the FX View:** IDR has been increasingly sensitive to the CNY and to US-China trade-war headlines of late. The currency slipped -1.4% against the USD before steadying recently after Jokowi was declared to have won 55.5% of national vote compared with challenger Prabowo Subianto's 44.5% by the General Elections Commission in Jakarta. Market exuberance was dented by Probowo's allegations of "massive cheating" (which was rejected by the Election Supervisory Board) and the deadly street protests that erupted in Jakarta. USDIDR touched a high of 14488 before coming off after President Widodo pledged to ensure stability, security and democracy. Governor Warjiyo also reiterated that BI will remain in the market to calm the rupiah in line with its fundamentals.
- In addition, his appointments for the key economic ministries, particularly Finance, will be closely watched with the appointment of

a potential new Chief to the Finance Ministry highly anticipated as Sri Mulyani Indrawati is rumoured to be given a more powerful position of the Coordinating economic Minister. The build-up in expectations that Jokowi and his economic team will follow-through with further fiscal policies that will ensure not only economic growth but tame the twin deficits as well.

- As a bonus, Indonesia's credit rating was upgraded to "BBB" by S&P from "BBB" on "strong economic growth prospects and supportive policy dynamics", plunging the USDIDR below 14300 on 31st May. This is a testament to the work of current FinMin Indrawati fiscal consolidation efforts as the credit agency stated that the sovereign ratings is supported by the government's relatively low debt and its moderate fiscal performance.

- In addition, his appointments for the key economic ministries, particularly Finance, will be closely watched with the re-appointment of Sri Mulyani to the Finance Ministry highly anticipated. News of her re-appointment could fuel gains in IDR. This is because of the build-up in expectations that Jokowi and his economic team will follow-through with further fiscal policies that will ensure not only economic growth but tame the twin deficits as well.

- Some of the measures that are likely to be implemented in Jokowi's second term or have already been implemented include tax reforms (of tax rule revision to support the property sector, removing value-added tax on some service exports, revising corporate taxes for coal miners, etc.) and changes to the "Negative Investment List" to open up previously partly closed sectors to foreign ownership. There could also be an extension and expansion of import tightening measures (including tariffs) and measures to encourage exports to curb the current account deficit (CAD). Other measures already announced included intensifying the use of biodiesel to reduce import of oil given its status as a net oil importer.

- Some of the fiscal reforms that can be expected include (1) continuation in tax reforms, (2) optimizing non-tax income, (3) increasing savings from export receipts in domestic accounts, and (4) better and stronger coordination of fiscal and monetary policies in order to improve financing availability, lower interest, and increase GDP. These measures to bolster growth and curb the current account deficits are positive for the IDR, and could potentially lead to a repricing of Indonesian assets and spur greater inflows.

- The confirmation of a Jokowi win should have encouraged further inflows but market optimism was crimped by the street protests as well as the external headwinds emanating from the US-China trade conflict. The risk-off sentiment that dominated much of May spurred outflows. Between 1-23 May, foreigners have sold U$622.3mn of equities while U$678.7mn of bonds has been sold for the month as of 21 May. Intervention has capped the USDIDR recently and we see potential for downside once the street protests fade. The broad USD direction matters as well and our base case expects a "Grey Swan" in the current trade war between the US and China that could eventually weaken US activity momentum and increase the expectations for Fed to ease monetary policy. Without the fiscal impulse of 2018 and as US growth continues to lose momentum, the USD could soften mildly but we expect USDIDR to remain supported on dips given the uncertainty and its sensitivity to US-China trade war headlines. The absence of further retaliation could mean a reversion to a low-volatility environment and allow room for USDIDR to trade lower towards 14500 in 3Q.

- **Growth and Inflation Outlook:** Growth decelerated to 5.07%y/y in 1Q2019 from 5.18% in the quarter prior, underpinned by the domestic consumption expenditure growth which strengthened from 5.10%y/y to 5.25% in 1Q. Household consumption steadied at around 5.01%y/y vs. previous 5.08%. Total consumptions of non-profit institutions serving households and government strengthened from 10.79%y/y and 4.56%y/y, respectively, in 4Q18 to 16.93%y/y and 5.21%y/y, subsequently, in 1Q19, buoyed by infrastructure developments and various government incentive programs ahead of the general election campaign period. Looking forward, our economic team expects the economy to strengthen in 2Q19, driven by domestic consumption activities such as the momentum euphoria of the election, Ramadan and Festive holiday. The current political violence at home may still crimp on activity. FinMin Indrawati had told the press recently that Indonesia takes a “more cautious approach towards expectations for economic growth amid an escalation in trade tensions between the US and China and an outbreak of political violence on the domestic front”.

- Headline inflation picked up pace to 2.83%y/y in Apr from previous 2.48%, underpinned by the surge in the food inflation ahead of Ramadan season and greater consumption during the National Election. Core inflation also inched higher to 3.052%y/y from previous 3.032%, lifted by the volatile subcomponent. The government’s move to curb imports and the current account deficit and the 175bp rate hikes by BI should continue to cap prices. The 7.5% tariff on around 900 consumer goods should reduce demand for imported goods and put downside pressure on prices. Our economist expects inflation to remain firm into May and June due to Moslem Festivity. Both government and corporates tend to provide extra allowances during this period but inflation should still remain within the BI’s target range of 2.5 and 4.5% for 2019.

- **Monetary Policy Forecast:** BI will have its next monetary policy next month on the 20th and the central bank recently said it may consider room to ease policy. Governor Warjiyo had told the local press that the policy stance is currently “cautious neutral” and data dependent. With inflation likely to remain firm on strong domestic consumption (albeit within the central bank’s target range), it may not be timely for the central bank to start easing now. In addition, rupiah has been under pressure and risk sentiment could keep the currency on the backfoot and increase its import bill in a period of festive spending. BI would likely watch for any signs of deterioration in activity and support the rupiah by sporadic interventions. We thus anticipate that the reverse repo rate would be kept at 6.00%. Deposit and lending facility rates should be left unchanged at 5.25% and 6.75% respectively, keeping the interest rate corridor at 75bp on either side of the policy rate. In the meantime, BI relies on liquidity-supportive measures to bolster domestic demand.

- As we have stated before, the measures included: (1) Increasing available liquidity and supporting financial market deepening by strengthening the monetary operations strategy; (2) Enhancing retail payment efficiency by expanding National Clearing System (SKNBI) services, namely through an extended settlement time with faster settlement, an increase in the nominal transaction ceiling and lower tariffs; (3) Increasing the supply of Domestic Non-Deliverable Forward (DNDF), in particular by simplifying the regulations concerning underlying transactions; (4) Implementing market operator regulation in the money market and foreign exchange market; (5) Developing the Commercial Papers (SBK) market as an alternative source of short-term funding for the corporate sector; and (6) Expanding electronification of the noncash social aid program (bansos), village fund program, transportation sector and fiscal operations.

- **Latest Fiscal and External Balance Outlook:** The budget deficit for Indonesia came in at 0.63% of GDP for Apr due to the pressure in external demand. State revenue came in to be IDR530.7trn consisting of 387trn of tax and 49.4trn of customs and excise. State expenditure was IDR631.8trn, resulting in a budget deficit of IDR101trn.

- On the other hand, external demand was weak with exports down -13%y/y in Apr and imports -6.6%y/y lower, resulting in a trade deficit of $2.5bn, way above the $509mn deficit expected by consensus and the widest in more than a decade. The fall in exports were driven mainly by the slump in the shipments of oil and gas. The fall in global trade and demand would remain a key concern watched by the Finance Minister and Bank Indonesia. Measures have been in place to curb imports but the fall in export earnings could worsen as trade war between the US and China becomes protracted.

- **Key domestic events and issues to watch**: GDP print for 1Q 2019 will be released on 6 May, while BI will meet to decide on monetary policy on 16 May. Market will be watching the election commission's certification of the winners in the Presidential and general elections due by 22 May (the law prescribes that the election results must be announced within 35 days of the vote).

- **Technical Outlook:** USDIDR continued to trade higher for the month of Apr, in line with call for rebound risks. Pair was last seen at 14260 levels. Bullish momentum on weekly and daily chart remains intact. Sustained price action above 14220 (23.6% fibo retracement of 2018 high to 2019 low) could see an extension of the rally towards 14425 (38.2% fibo), 14485 (200 DMA).

- **Technical Outlook:** 1M USDIDR NDF pulled back towards the 50-dma at around 14350 from 14505, weighed by the euphoria of the rating upgrade awarded by S&P. With that, the pair tests the 50-dma. Momentum on the daily chart has become more bearish but stochastics flag that oversold condition that could stem further bearish move. Still, risks are to the downside or this pair. Next support at 14260.

## PHP: Balanced and Constructive Outlook

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDPHP** | 52.30<br>(--) | 52.00<br>(--) | 51.90<br>(52.50) | 51.90<br>(52.80) |

*Previous Forecast in Parenthesis*

- **Motivation for the FX View:** We are broadly constructive on the outlook of PHP on a combination of factors including (1) receding political uncertainties as recent mid-term elections gave President Duterte a strong mandate to continue with his policies; (2) recent move by S&P to upgrade Philippines sovereign credit rating to BBB+ which is expected to be supportive of further foreign inflows; (3) BSP's RRR cut though may weaken the peso but is supportive of growth and activity; (4) softer oil prices in the interim (as demand could soften owing to US-China "grey swan" scenario) to help net oil importing FX such as PHP and INR; (5) PHP less vulnerable amongst AXJ FX in the environment of US-China trade tensions; and (6) though Philippines suffers from current account deficit, the deficit-to-GDP ratio is improving and is not a top concern as deficit is investment-driven and have been funded by relatively healthy inflow from tourism, Business process outsourcing receipts and OFWR. In light of the above-mentioned factors and Fed to slow its pace of policy normalisation (our house view expects no Fed hike for 2019-20), we made revision to our forecast for 4Q2019-1Q 2020 and look for USDPHP to trend modestly lower for the forecast horizon.

- In assessing AXJ FX sensitivity in the environment of escalation of US-China trade tensions, our study using CNH as independent variable in running OLS regression over the 1-Jan to 24-May 2019 (log values on daily close) shows that PHP's beta is relatively low at 0.22x while KRW, IDR, MYR, SGD, TWD and THB are at 1.1x, 0.63x, 0.6x, 0.43x, 0.35x and 0.2x, respectively. This suggests that an escalation of trade tensions is expected to see KRW, IDR, MYR, SGD and TWD under depreciation pressure while PHP and THB could be more resilient.

- **Upside Risks to Our FX forecast:** There are risks to our constructive outlook on the Peso, namely (1) if foreign inflows slowed then current account deficit outlook could be affected and this could expose PHP to downward pressure; (2) easing of monetary policies did not translate into any support for the economy and this could impact investor confidence; (3) Fed resumes rate hike resulting in global risk-off and foreign fund outflows. These factors could pose downward pressure on PHP.

- **Growth and Inflation Outlook: Our Economist revised 2019 growth forecast to +6%**, down from 6.5%, owing to the budget impasse and persistent contraction in net exports. The budget impasse resulted in the Government applying re-enacted budget instead of new budgets. That has negative macroeconomic impact in terms of slowing aggregate demand, hence economic growth, which in turn worsened the budget balance growth. Nonetheless growth is expected to recover in 2H to the 6 – 6.5% range as budget 2019 has finally been signed into law on 15th Apr and the ban on government spending now gets out of the way post-elections. The official forecast for 2019 is at 6 – 7%.

- 1Q growth decelerated to 5.6% y/y, down from +6.3% y/y in 4Q. The decline was due to a slowdown in government expenditure to 7.4% y/y for 1Q (owing to budget impasse which lasted till mid-Apr) from 12.6% y/y in 4Q and the consequential drag on private investment. Net export was another drag with exports slowing faster than the slowdown in imports. On the other hand, domestic demand held up well (+7.2% y/y in 1Q, from 6.1% in 4Q) via a pick-up in consumer spending. Industry breakdown showed construction sector growth fell sharply to 3.9% in 1Q from +20% in 4Q while manufacturing and services growth improved.

- **Inflation decelerated to +3.0% YoY in Apr** from the high of 6.7% YoY in Sep-Oct 2018 amid the ongoing non-monetary measures to curb inflation such as increasing supplies of key food items and improving their distribution while commodity prices cooled. Our Economist maintained their 2019 and 2020 inflation forecasts of +3.0% and +2.8% respectively. Meanwhile, BSP revised downward its 2019 inflation rate forecast further to +2.9% from +3.0% but raised 2020 forecast slightly to +3.10% from +3.00%. Although BSP expects monthly inflation rate to remain within its inflation target range of 2 – 4% in 2019-2020, risks could emerge from prolonged El Nino and higher than expected increases in global oil prices.

- **Monetary Policy Forecast:** Our house view continues to look for another 50bps cut to bring policy rate down to 4% this year, after the recent 25bps at the last meeting. This is based on our house assumption of stable Fed fund target rate for 2019-20, receding domestic inflation and downgrade in official growth forecast.

- At the last BSP meeting (9 May), the central bank cut policy rate by 25bps to 4.5%. Accompanying MPS sees slower global economic growth in 2019, while domestic economy faced the negative impact from delayed Budget 2019 approval. Nevertheless, overall prospect for the domestic activity continues to be firm, underpinned by projected recovery in household spending and sustained momentum in government's infrastructure spending. Meanwhile, the Monetary Board noted indications of slower growth in domestic liquidity and credit require careful monitoring.

- **Latest Fiscal and External Balance Outlook:** BoP position for period Jan – Apr saw a surplus of $4.27bn vs. deficit of $1.5bn in the same period last year. Strong performance of BoP can be attributed to remittance inflows from overseas Filipinos and net inflows of foreign portfolio investments in Jan-Feb. Our Economist noted that OFWR picked up to +6.6% y/y in Mar, up from 1.5% in Feb. This puts 1Q OFWR growth at 4.2% y/y. The strong inflow in Mar was dominated by higher flows from Asia in particular from Singapore and S.Korea while America was the second largest driver of OFWR. Current account deficit remains at 2.4% of GDP but IMF expects an improvement to 2.2% of GDP in 2019. Governor Diokno said he was "not at all worried about CAD especially if deficit is less than 3% of GDP as the composition of imports was for raw materials, equipments". He stressed that BoP position is manageable and provides resilience against external headwinds... external position is adequately supported by structural sources of FX inflow such as OFWR, IT/business-process outsourcing revenues and tourism receipts". His comments were also consistent with S&P's recent assessment - "the deficit is largely investment driven, and that this is a healthy development in light of its historical underinvestment".

- The S&P upgrade Philippines sovereign credit rating to BBB+ (30th Apr). The rating agency cited strong economic growth trajectory, solid government fiscal accounts and sound external settings for its upgrade to the Philippines ratings. This should support investor sentiment and spur inflows into Philippine assets, supportive of the PHP.

- **Key domestic events and issues to watch:** May inflation (5 Jun); May FX reserves (7 Jun); Apr trade (11 Jun); Apr OFWR (17 Jun); May BoP (19 Jun); BSP meeting (20 Jun); May budget balance (25 Jun).

- **Technical Outlook:** USDPHP traded higher in early May. The move higher more than met our first objective at 52.60. Intra-month high seen at 52.74 (20 May) before gains were retraced. Last seen at 52.17 levels. Bearish momentum is now showing up on daily chart with stochastics falling. Price action remains confined to the bearish trend channel formed since end-Nov 2018. A move lower towards 52 levels (50% fibo retracement of 2018 low to high), 51.50 (61.8% fibo) is not ruled out. Resistance at 52.60 (38.2% fibo), 52.80 (200 DMA).

## THB: Weighed On By In-fighting

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDTHB** | 32.00<br>(--) | 32.00<br>(31.70) | 31.80<br>(32.00) | 31.80<br>(32.20) |

- **Motivation for the FX View:** Thus far in May, the THB has performed relatively well compared to its Asian peers, gaining 0.4% around the USD when most others softened. Despite some signs of economic growth holding up above 3%, we are wary of the fractious nature of its new government. It could take some time before the government sorts out its in-fighting and puts in place new robust policies which can assure investors of growth sustainability. Once the recent exuberance surrounding a potentially larger weighting in the MSCI Emerging Markets index wears off, a mix of domestic (political feud) and external (prolonged, expanded trade war) concerns could provide some impetus for the USDTHB to head towards 32.00 by end 2Q, from 31.80 currently. The pair could then trade ranged with some degree of volatility, amid the protracted Sino-US negotiations. Towards the end of the year, if a Sino-US trade deal starts to take shape, and some semblance of political détente among the different Thai political camps is achieved, there could be a tentative lift to the THB.

- The political environment has been split into two camps—the pro-junta group led by the Palang Pracharath Party (PPRP) and the anti-junta group led by the Pheu Thai Party (Thaksin-linked party) and new up-start the Future Forward Party. Neither sides have sufficient seats to form a majority (251/500) in the House of Representatives and would need a coalition with smaller parties. At the moment, it seems likely that PPRP will be able to gain a slim majority, although potential coalition allies such as the Democrats (52 seats) and Chartthai Patanna (10 seats) have expressed new reservations and conditions for the coalition. Notably, allowing Prayuth to remain as PM—one of PPRP's key goals in campaigning—will likely be met. The Constitution is stacked in PPRP's favour, as an additional 250 junta-appointed Upper House senators will vote along-side the 500 elected-MPs to select the PM (376/750 votes required).

- The closeness of the split in electorate votes reveals the wide schism in Thai politics. Even if Prayuth remains PM, close to half of the elected lower house will likely continue to oppose the pro-junta coalition and its policies. The possibility of an unstable and potentially short-lived government could keep foreign investors on the side-lines, especially for big-ticket, longer-term projects involving infrastructure and production facilities. Even as PPRP's progress in coalition-forming (and likely slim majority) has eased some of the downward pressures on the THB, we see it unlikely that investor concerns on political risks will dissipate fully in the quarter.

- Net purchases of Thai bonds ($527mn mtd) had offset a small net outflow from equity assets ($66mn mtd) to provide some support for the THB. However, this does not give Thai assets a clear vote of confidence by investors. Most of May had actually seen net equity sell-offs by foreigners, and this was only mitigated by a surge in foreign buying of equities on 28 May ($393mn). Reports link this to speculation that the inclusion of non-voting depository receipts (NVDRs) into MSCI's emerging markets index could increase the weighting of Thai stocks in MSCI portfolios. Once this idiosyncratic exuberance subsides, further net foreign outflows cannot be ruled out should political clarity and domestic green shoots remain lacking. This could continue to keep the THB under pressure in the month ahead. Nonetheless, we do not expect large upward moves in the USDTHB pair. As the trade war drags on and US growth momentum wanes, markets could be increasingly looking out for signs of a Fed easing bias. This could contribute to a softer USD in the latter part of the second half of the year, and cap the extent of step-ups in USDTHB in the two quarters ahead.

- **Growth and Inflation Outlook:** In end-April, the Thailand Finance Ministry cut its 2019 growth forecast to 3.8% from 4.0% previously, citing weaker exports linked to rising protectionism. The forecast for exports was also cut by more than 1% point to 3.4% from 4.5% previously. The Ministry of Commerce cautioned that US' Huawei ban could have a short-term impact on the Thai economy given its role in providing intermediate inputs to China. Our Economist similarly downgraded the growth forecast for Thailand this year to +3.2% (from 3.6% previously), given the worse-than-expected 1Q GDP and the broadening of the trade war into tech dimensions. They also highlight that Budget 2020 could face delays from a divided government, which could weigh on public investment. The only bright spot could be private investment, as Thailand could be the beneficiary of investment diversions as a result of the trade war, although this would take some time to be realised. Our Economist maintains the headline inflation forecast at +1.1% for 2019, compared to BOT's forecast of 1.0%.

- GDP growth in 1Q was +2.8% y/y (vs. +3.6% in 4Q18), a 4-year low mainly on account of a sharp fall in exports, softer private consumption and private investment. Exports of goods and services saw its worst decline since 4Q11, coming in at -4.9% y/y (vs. +0.7% in 4Q). Private consumption fell below 5% to +4.6% y/y (vs. +5.4% in 4Q), alongside tentative signs of weakness in the labour market—contractions in farm income (-0.3%) and agriculture employment (-4.2%). Private investment growth also saw some easing, to +4.4% y/y in q1 (vs. +5.5% in 4Q), due to modest dampening in machinery & equipment as well as construction growth. From the sectoral perspective, most sectors saw a dampening in growth momentum. Manufacturing recorded mild growth of +0.6% y/y, its slowest pace in 3 years. Accordingly, the weakness spilled over to trade-related services such as freight water transport, leading transportation & storage growth to come in at +3.4% y/y (vs. +5.4% in 4Q).

- Headline inflation came in at +1.2% y/y in Apr, similar to the pace in Mar. Food prices had eased slightly (+2.2% vs. +2.4% in Mar), due to softer price increases in meat, poultry & fish, rice & cereal. Energy prices (+2.3% vs. Mar: +2.1%) also edged up, alongside the Brent price rise to USD72 a barrel in the month, and contributed to an uptick in transportation costs (+1.1% vs. +0.8% in Mar). Core inflation (headline inflation excl. raw food and energy) remained steady at +0.6% in Apr, unchanged for the third month.

- **Monetary Policy Forecast:** At its 8 May policy meeting, the BoT monetary policy committee had voted unanimously to keep the benchmark one-day repurchase rate steady at 1.75%, reiterating that "current accommodative policy would remain appropriate". This is the second unanimous vote, compared to the split vote in Feb (2 out of 6 members voted for hike). The decision was attributed to heightened global and domestic uncertainties in the current period. The political uncertainty highlighted above, coupled with expectations of softer economic growth this year, should allow the BoT to be patient in its rate normalisation process. At the same time, potential signs of a Fed easing bias will help reduce pressure on the BoT to hike. Our Economist expects the BoT to maintain its policy rate in 2019, and to resume its monetary policy normalization in 2020 due to financial stability risks.

- **Latest Fiscal and External Balance Outlook:** Though the USD100bn FY2020 budget has been approved by the cabinet, there is an increasing likelihood that its implementation on 1 Oct 2019 could be delayed. It has been two months since the general election took place on 24 Mar, and while there has been some progress on coalition forming (with the PPRP-led alliance expected to gain a slim majority), no formal confirmation of the new government make-up has been announced. As highlighted earlier, the fractious nature of the new parliament, with each party garnering less than 30% of votes, could result in bitter political wrangling. If this leads to a longer-than-expected delay in infrastructure investment and implementation, it could dampen economic growth in 2019 and negatively impact sentiments.

- The current account surplus dipped modestly to USD6.1bn in Mar after ballooning to USD6.5bn in Feb from USD2.0bn in Jan. Goods trade surplus in Mar actually edged up to USD3.6bn from USD3.5bn in Feb, alongside a m/m improvement in exports. Notably, trade surpluses for Feb and Mar were significantly higher than the preceding 6-month average of around USD1.1bn. Nonetheless, services, primary and secondary income components came in lower at USD2.5bn in Mar compared to USD3.1bn in Feb. For 1Q as a whole, the current account surplus widened significantly to USD14.6bn (vs. USD7.1bn in 4Q). Imports for the quarter had declined by -2.9% (vs. +7.5% in 4Q), due to lower demand for raw materials, intermediate and capital goods.

- **Key domestic events and issues to watch:** BoT will meet to decide on monetary policy on 26 June, and minutes will be released on 10 July. May Nikkei PMI (3 June); May CPI (4 June); May Exports and Imports (28 June); Current Account and BOP (28 June).

- **Technical Outlook:** Our caution for USDTHB to retrace downwards towards 31.88, 31.70 (as shared in the last FX Monthly) materialized, although the trough of 31.45 (14 May) was lower than expected. Last seen at 31.80 levels. Bullish momentum on daily chart has faded while stochastics is turning lower. Support is around 31.59-levels (50% fibo retracement of the 2019 low to high), 31.47-levels (61.8% fibo). Resistance around 32.11 (recent high in April). We see range of 31.6 to 32.1 holding in the interim until more political certainty emerges.

## INR: Another Rate Cut Expected

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| USDINR | 69.50<br>(68.00) | 69.50<br>(67.00) | 69.00<br>(68.00) | 68.50<br>(68.00) |

*Previous Forecasts in Parenthesis*

- **Motivation for the FX View:** Modi's single party victory received strong support from foreign investors that also brought the USDINR under the 70-figure. The broad USD strength that brought most AXJ lower, did not do as much damage for the INR. In fact, INR has been rather resilient to the US-China trade tensions as well as the boost that it receives from the General Elections. Month-to-date, INR only weakened -0.1% vs. the USD compared to a range of 0.5-2.6% seen in the rest of the region. THB is the other exception, with a gain of 0.4%.

- Month to date, equity-related flow reversed in favour of the rupee with \$612mn of equities snatched up in the week that ends on 24th May although net equity flow remains negative for 1-24th May at -95.7mn. Bond-wise, external demand has been weak but still positive. Foreigners bought \$159.3mn of local debt in the week that ends on 24th May. It remains to be seen if the optimism would run out of steam soon. Investors are likely to want to look for reforms. RBI has acted to introduce a new framework to shore up the liquidity buffers for non-banking financial companies (NBFCs). With that, we anticipate the CRR cut on 6th of Jun (RBI meeting) as well as the reverse repo cut of 25bps that is already priced. The additional CRR cut could be deemed supportive of domestic demand and strengthen the rupee.

- **Growth and Inflation Outlook:** Industrial production slipped -0.1%y/y in May, another miss that increases rate cut expectations in Jun. The breakdown shows decline in manufacturing output that outweighs weak growth in electricity and mining. Capital goods and intermediate goods declined along with consumer durables. Infrastructure/construction goods picked up pace to 0.8%y/y from 0.3%. Exports weakened to 0.6%y/y in Apr while imports picked up pace to 4.5%y/y from 1.4% on the back of a bigger oil import bill (9.3%y/y from previous 5.6%), resulting in a wider trade deficit of \$15.3mn.

- Activity numbers have been in the downtrend along and expectations are for 1Q GDP to decelerate towards 6.3%y/y from previous 6.6%.

- Inflation remained subdued with CPI at around 2.92%y/y vs. previous 2.86%, a tad firmer due to the rise in food inflation and higher fuel price. Eyes are on the monsoon whose onset has been reportedly forecasted to be delayed from 1st Jun to 4th Jun which could in turn hurt the harvest of rice, cotton and soybeans.

- **Monetary Policy Forecast:** With activity data softening in Apr, there is an increasing likelihood for RBI to deliver another 25bps cut in Jun. In fact, this has been gradually been priced throughout May. External demand is also soft with exports deteriorating in Apr to almost flat, not entirely shielded from the shock to international trade from the US-China trade war. Even as INR has been one of the most resilient currencies in May, the recent re-escalation could increase the urgency for the central bank to lower lending rates further, taking advantage of the subdued inflation environment. 10y yield has fallen around 30bps to levels around 7.1%. A dovish statement from RBI could keep 10yr yield pressed towards the 7.0%.

- Apart from supporting growth momentum, the focus of the RBI seems to be forcing a build-up the capital buffers for non-bank finance companies (NBFC). Recently, RBI has issued a guideline that demands NBFCs to set aside a liquidity buffer by purchasing high-quality liquid assets. The new liquidity framework could begin next Apr. With a potential of greater liquidity demand from NBFCs as they prepare for the start of the new framework that takes effect in a year, RBI may want to lower cash requirement reserve and increase the size of their

OMOs to support liquidity. We anticipate CRR to be lowered by 25bps to 3.75%.

- **Latest Fiscal and External Balance Outlook:** As of last available data, India's current account deficit narrowed in 3Q FY18-19 to U$ 16.9bn from U$19bn. The next data for 4Q FY18-19 would be due in June. This year could be another challenging one for its external balance as global growth continues to moderate and crude price inflates the oil import bill.

- **Key domestic events and issues to watch:** 1Q GDP due on 31$^{st}$ May; PMI-mfg on 3$^{rd}$ Jun; BoP Current Account Balance at 1Q between 5-28$^{th}$ Jun; CPI and IP on 12$^{th}$; trade data on the 12-15$^{th}$ ; WPI on the 14$^{th}$.

- **Technical Analyses:** The 1M USDINR NDF hovers within around the 70-figure as the initial euphoria of Modi's win wears off and pair is back to being swung by global risk appetite. Still, a decline in the oil price caused by increasingly negative view of global demand. That could still be a mitigating factor for INR weakness. Next resistance seen around 70.40 (50-dma) before the next at 70.60. Eyes on this resistance. A failure to break through this area of resistance (70.10-7.60) could mean a head and should bearish reversal set up. Support is seen around 69.90 before 69.50.

## VND: Weighed By US-China Trade War

| Forecast | 2Q 2019 | 3Q 2019 | 4Q 2019 | 1Q 2020 |
|---|---|---|---|---|
| **USDVND** | 23250<br>(23100) | 23200<br>(23000) | 23200<br>(23100) | 23300<br>(23000) |

*Previous Forecasts in Parenthesis*

- **Motivation for the FX View:** The moves in May proved us wrong as the US-China trade truce quickly regressed into trade war. The moves up in the USDCNY led the USDVND higher as well and the broad USD strength did not help in the least. A binary event such as the US-China trade war typically renders any position taken to be more of a gamble than a calculated move. With that, it is also possible to say that markets have re-priced the US-China trade development. Should CNY remain stable, VND may also get some support and we think that China seems more determined the keep the exchange rate stable at this point. 1) CBIRC Guo Shuqing warned against shorting the RMB; 2) PBoC quarterly reports indicate a pledge to keep the exchange rate steady; 3) PBoC to issue more yuan bills in Hong Kong, possibly to keep the cost of shorting the CNH expensive. 3M CNH Hibor had shot up towards 4% before coming off more recently to 3.44%. 4) The increasing spread between our USDCNY fixing estimates and the actual spreads in the periods of USD upmove and trade war headlines suggest the presence of the countercyclical adjustment factor. We definitely see more potential for CNY to stabilize under the 7-figure for now. That could also limit the upmove for the USDVND. That said, VND enters a rather seasonally weak month and we expect recovery in the VND against the USD to remain limited.

- Vietnam continues to see steady FDI inflows as well as portfolio inflows. FDI inflows for May maintained its momentum at around U$1.1bn. In an environment of USD strength, VND's competitiveness against its trading partner waned. Our estimate of the VND trade weighted index (TWI) edged higher to 64.70 at last sight (27 May) vs. 64.1 in Mar as most of its trading partners depreciated more against the USD (including the RMB) compared to the VND. The deterioration in trade relation between the US and China suggests that a trade deal within the quarter is less likely than before. A Grey Swan scenario that includes a period of the upcoming tariff hike by China to be imposed on the US exports to China and a period of uncertainty revolving around the US-China tensions thereafter to see USDVND hovering at an elevated range of 23300-23420.
- We hold our view that slower global growth is likely to crimp on the VND and that could be worsen as US and China slaps more tariffs on each other's goods. Moderation in global growth had weighed on exports growth in the past few months for Vietnam with single digit growth/ contractions recorded for the past few months. Trade balance swung back into deficit for Apr at -U$700mn vs. the U$600mn surplus for Mar. In fact, the government has urged ministries and provincial units to launch drastic measures to meet the growth target for this year in the face of rising trade tensions. On a related note, the US Treasury has refrained from labelling Vietnam a currency manipulator, after receiving a set of unnamed data. However, the Trump administration now wants to impose tariffs on countries that has "undervalued currencies". Valuation, according to the US Commerce Department, is done via a 2-step benefits analysis in determining the country's REER and equilibrium REER as well as its nominal and actual bilateral FX. The difference of the nominal and actual average nominal bilateral exchange rate could demonstrate the existence of a "benefit" from currency appreciation.
- **Growth and Inflation Outlook:** As of last available data, PMI-mfg rose to 52.5 for Apr vs. 51.9 in the month prior. Respondents to the survey conducted by Markit reported solid rise in new orders and the first rise in hires seen in the last three months. Business confidence was also greater in Apr.
- Industrial production rose to 10.0%y/y in May from previous 9.3%, underpinned by stronger growth in manufacturing, electricity output and water supply. Retail sales steadied at around 11.6%y/y for the first five months of the year vs. 11.9%y/y seen in Jan-Apr as Tourism softened a tad to 12.4%y/y from previous 13.1%.
- CPI came in at 2.88%y/y for May vs. expected 2.80%, albeit still softer than the previous 2.93%. Inflation pressure could continue to stay firm amid reports of 1.6mn pigs culled to contain the African Swine Fever. High base effects on the other hand, could mitigate the upside pressure on the headline and keep it under the 4% target.
- In the meantime, trade deficit almost doubled to $1300mn from previous $700mn as imports slowed to 8.3%y/y from previous 17.6%, though still outpacing exports growth at 7.5%.

- Our economic team maintains their full year GDP forecast at +6.8% for 2019, pending Vietnam's 2Q GDP growth figures which will be released in end-June 2019. For the second quarter, growth could quicken to +6.9% given better-than-expected manufacturing and exports performance in recent months.
- **Monetary Policy Forecast:** Rising inflation could narrow the room for monetary policy support in a backdrop of slowing global demand for Vietnam's export performance. While Vietnam seems to have benefitted from diversion flows and FDI that resulted from the US-China trade conflicts, VND could stand to strengthen further from a stronger demand out of China given that China is still its biggest export destination. We still expect FDI inflows to continue because of the trade agreement/diversions and that could cushion the effects of the decline in external demand. Sustained imports growth and retail sales suggest that household consumption could also support growth.
- In this environment where growth outlook for Vietnam is still rather balanced, we see little need for a rate cut by SBV now. In terms of TWI, the VND strengthened as the currency tends to be resilient relative to other regional peers because of its relatively closed capital account, managed exchange rate policy as well as intervention in the FX market by the central bank. SBV had said that it is willing to sell USD to stabilize its exchange rate. Within the month, VND could have also gotten some support from equity-related inflows this month with foreigners buying a net $193.3mn of equity as well. Strong foreign direct investment can also cushion the VND from excessive weakness.
- **Latest Fiscal and External Balance Outlook:** As of last available data, current account surplus was at U$1.24bn in 2Q. Net trade surplus of goods slipped to U$3.0bn from previous U$5.2bn. The competitive dong could keep the current account in surplus Slower growth momentum could mean a deterioration on the trade front and we expect the current account surplus to be eroded. That would underscore the need for VND to remain competitive and our view that VND could lag in its recovery against the USD compared to regional peers.
- **Key Domestic Events and Issues to Watch:** PMI-mfg on 3rd Jun; domestic vehicle sales in 6th-13th; CPI, trade numbers, retail sales and IP are due 25th-30th Jun.

## FX Forecasts

| | End Q2-19 | End Q3-19 | End Q4-19 | End Q1-20 |
|---|---|---|---|---|
| USD/JPY | 109 | 108 | 109 | 110 |
| EUR/USD | 1.1150 | 1.1200 | 1.1250 | 1.1300 |
| GBP/USD | 1.2600 | 1.2700 | 1.2700 | 1.2800 |
| AUD/USD | 0.6800 | 0.6800 | 0.6900 | 0.7000 |
| NZD/USD | 0.6500 | 0.6400 | 0.6400 | 0.6600 |
| USD/SGD | 1.3850 | 1.3850 | 1.3800 | 1.3750 |
| USD/MYR | 4.20 | 4.20 | 4.17 | 4.17 |
| USD/IDR | 14500 | 14500 | 14200 | 14200 |
| USD/THB | 32.00 | 32.00 | 31.80 | 31.80 |
| USD/PHP | 52.30 | 52.00 | 51.90 | 51.90 |
| USD/CNY | 6.98 | 6.98 | 6.95 | 6.92 |
| USD/HKD | 7.85 | 7.84 | 7.84 | 7.83 |
| USD/TWD | 31.80 | 31.80 | 31.50 | 31.20 |
| USD/KRW | 1195 | 1195 | 1185 | 1170 |
| USD/INR | 69.50 | 69.50 | 69.00 | 68.50 |
| USD/VND | 23250 | 23200 | 23200 | 23300 |
| DXY Index | 98.91 | 98.27 | 98.07 | 97.77 |
| SGD Crosses | End Q2-19 | End Q3-19 | End Q4-19 | End Q1-20 |
| SGD/MYR | 3.0325 | 3.0325 | 3.0217 | 3.0327 |
| SGD/IDR | 10469 | 10469 | 10290 | 10327 |
| SGD/THB | 23.10 | 23.10 | 23.04 | 23.13 |
| SGD/PHP | 37.76 | 37.55 | 37.61 | 37.75 |
| SGD/CNY | 5.04 | 5.04 | 5.04 | 5.03 |
| SGD/HKD | 5.67 | 5.66 | 5.68 | 5.69 |
| SGD/TWD | 22.96 | 22.96 | 22.83 | 22.69 |
| SGD/KRW | 863 | 863 | 859 | 851 |
| SGD/INR | 50.18 | 50.18 | 50.00 | 49.82 |
| MYR Crosses | End Q2-19 | End Q3-19 | End Q4-19 | End Q1-20 |
| EUR/MYR | 4.68 | 4.70 | 4.69 | 4.71 |
| JPY/MYR | 3.85 | 3.89 | 3.83 | 3.79 |
| MYR/HKD | 1.87 | 1.87 | 1.88 | 1.88 |
| MYR/CNY | 1.66 | 1.66 | 1.67 | 1.66 |
| GBP/MYR | 5.29 | 5.33 | 5.30 | 5.34 |
| AUD/MYR | 2.86 | 2.86 | 2.88 | 2.92 |
| NZD/MYR | 2.73 | 2.69 | 2.67 | 2.75 |
| MYR/IDR | 3452 | 3452 | 3405 | 3405 |
| MYR/INR | 16.55 | 16.55 | 16.55 | 16.43 |
| MYR/KRW | 284.52 | 284.52 | 284.17 | 280.58 |
| MYR/PHP | 12.45 | 12.38 | 12.45 | 12.45 |
| CNY/MYR | 0.6017 | 0.6017 | 0.6000 | 0.6026 |

Source: Maybank FX Research as of 31 May 2019.
*These forecasts are meant to be indicative of FX trends and not meant to be point forecasts.

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