MACRO | FX RESEARCH | Global

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FX Monthly

2016, Issue VI: Should We be Worried About Post-Brexit Uncertainty

Key themes[1]

- First, US Fed timeline for eventual future rate hike remains data dependent. US growth recovery remains on track but recent global developments out of China and *enhanced* volatile market activity *due to Brexit may potentially affect the number of hikes in 2016. Generally expect USD to be more mildly positive now. We are now not expecting a hike in 2016 and at most 1 hike in 4Q at the most.* Key US events: *ISM Manufacturing Mar (1 Jul) (expected: 51.4); Factory Orders (5 Jul); June FOMC minutes release (7 Jul); US Beige Book (14 Jul); US May NFP (8 Jul) (expected: 180k); CPI (15 Jul); GDP 2Q (29 Jul); FOMC decision (28 Jul). Fed Lockhart speaks in Idaho (14 Jul); Fed George speaks in Oklahoma City (15 Jul).*

- Second, Japan's 2% inflation target has been pushed back to 2H FY 2017 (by Mar 2018) due to oil softness and slow traction in wage increases. The credibility of Abenomics has waned somewhat in 2016 even though the easing bias is still clear. We do not expect any further moves by the BOJ until Jul meeting at the earliest and further jawboning is likely until then. Postponement of the consumption sales tax hike to Oct 2019 is now very likely, removing a likely drag on the economy. *BOJ meets on 29 Jul to decide on policy. CPI (29 Jul)There is also the final print of 1Q 2016 GDP due on 8 Jun. JGB auctions in Jun: 10-year (5 Jul), 30-year (12 Jul), 5-year (14 Jul), 1-year (15 Jul) and 20-year (20 Jul).*

- Third, *post-Brexit, odds are rising for ECB to cut rate by another 10bps, but we think it remains too early to tell. To be sure, Brexit creates EU contagion risks. It is likely to see more Far Right parties within the Euro-group (in Spain, Italy, France) to call for "Leave EU" referendums. The second order effects of a Brexit on the future of the Euro-club could be further undermined and this could further heighten market volatility and trigger risk-off sentiment in the short term. EUR is likely to remain under pressure towards 1.07-1.08 levels. We expect ECB to monitor market development, assess impact of the UK-fallout and not take hasty action remain while still adopting an easing bias at the upcoming meeting (21 Jul). We believe ECB stands ready to provide additional liquidity measures, when necessary. Data/Events we are watching for the month ahead includes Jun CPI (15 Jul); Jul ZEW survey (19 Jul); ECB meeting (21 Jul); Jul Flash PMIs out of Eurozone (22 Jul) and Euro-area Jul confidence data (28 Jul).*

- Fourth, *China still has excess capacity, heavily indebted corporations and huge liquidity injections continue to add immense pressure on the economy and the yuan medium term. PBOC continues to rely on SLF, MLF and PSL as liquidity tools, we do not rule out interest rate cut of 25bps and RRR to be cut in intervals by another 100bps in the second half of the year. 2Q GDP and activity indicators (i.e. urban investments, industrial production and retail sales) will be eyed on the 15th. Jun PMI-mfg is due on 1 Jul along with Caixin version. Foreign reserves is scheduled for release on the 7th. CPI and PPI on the 10th. Liquidity numbers are due from 10th-15th. We also eye potential inclusion into MSCI and JPM bond indexes.*

- *We could see some USD support as cautious risk sentiments may linger post Brexit. In the lead up to Jul/Sep/Dec FoMC, USD could be more supported against G7 majors (i.e. GBP and EUR) than against AXJs. High yield plays may emerge, lending support to AXJs (IDR and MYR)*

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

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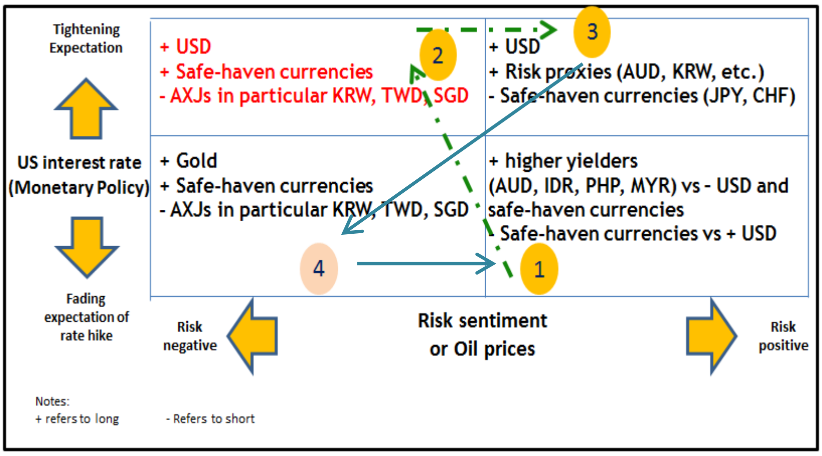
So what?



- **Macro Themes:** We have revised our view now in line with our Economics team that Fed will likely not raise target rate in 2016. However, we still see some risk of at least one 25bps move in 4Q 2016. Dollar rose above the 95-level at last sight following Brexit and is currently at around 96 levels. Despite Fed Fund Futures showing only signs of a 12% of a Dec hike, the heightened risk aversion from Brexit and concerns about unknowns, should ensure the dollar tone remain supported into July. Risk assets have so far softened, with brent now below USD50-level and US equities down sharply. We anticipate a potential shift towards the bottom left quadrant in the 2by2 grid shown above with safe haven currencies and dollar strength as well as gold likely to benefit.
- **Major Currencies:** UST curve now suggests that markets expect no hikes this year and at the very most only 1 hike in Dec but we still need to see if economic data will improve significantly after Brexit as risk premiums have risen slightly. Put that together USD could strengthen slightly. EU-UST bond yield differential have narrowed slightly suggesting some support for EURUSD but rates differentials in current risk off environment may not be fully indicative. We are likely to see currencies with stronger sovereign credit ratings such as AUD, SGD and higher yields possibly see some inflows as selective purchases materializes. RBA has acted decisively with a rate cut in the seasonally weak month for AUD and that has dragged the AUDUSD towards levels around 0.72. The Election Campaign into polling day on 2 July, could see more volatilities in the currency. Any surprises out of the election could see AUD weakening further.
- **China:** CNY adjustment is not over but PBOC is likely to continue to keep yuan stable to stem capital outflows as the economy remains under pressure. Markets seem to be convinced of the central bank's ability to ensure yuan stability and downside pressure has eased significantly. Weak corporate lending and investment and stronger dollar will likely weigh on China growth and bearish yuan bets are likely to persist. However, capital account reforms continue and should serve as a buffer for the CNH and keep it from underperforming sharply. We eye the moves of USD and the RMB index and look for rangy moves between 6.60-6.70 for much of the rest of 2016 with some upside risks in the near-term.
- Taking into consideration the *Brexit* event and its potential negative repercussion that could linger into 3Q and early-4Q (UK PM steps down by Oct), the shift in our expectation for no Fed hike this year, potential uncertainty leading into US elections (in Nov 2016), we see cautious risk sentiment for 2H 2016 and this could

lead to mild support for USD. But we think USD could be more supported against the G7 majors (in particular the EUR and GBP) than against the AXJs. We see potential inflows into AXJs as markets search for higher yielding plays amid a near-zero rate environment (in the developed world). In the medium term, we favor IDR and MYR. Risks to our view are further developments out of Eurozone in response to the Brexi that could potentially trigger a financial meltdown, sharp deterioration in China's growth, crude supply overhang that could drag on oil price and a Donald Trump Win.

G7 Global Overview

USD: Enhanced Dollar Strength in the Making

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD Index	99.84 (95.14)	99.75 (96.78)	99.89 (96.84)	98.88 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We now expect not rate hike in 2016. We do caution that additional repricing of a surprise Fed hike in July, Sep or Dec (due to market complacency over Fed rate hike trajectory) could continue to see UST yields higher in particular Treasuries 2y and below, and see **USD strength (buy the rumor) in the lead-up to the FOMC** meetings. At the same time the GBP decline thus far would require some repricing in FX markets and coupled with lower risk sentiment and rising risk premiums, before it affects global consumption, investment growth and then the real economy. During this transition phase and around FOMC announcements, we believe the **USD could be broadly supported**.
- Recent economic data including home sales, retail sales, consumer sentiment, durable goods orders have remained generally firm but recent data have been mixed particularly with the recent low figures for the NFP. Labor market is at or near full employment and inflation progressing towards Fed's medium term objective of 2% but recent June FOMC statement indicates that pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up. Although the unemployment rate has declined, job gains have diminished. Growth in household spending has strengthened. In the post statement conference, Yellen highlighted the UK referendum as one potential reason why a Fed rate hike may need to delayed.
- Recent developments post Brexit, have led to increased risk aversion and concerns about impact on global growth. We do observe there have been ongoing adjustments with regards to Fed rate hike expectations - Implied probability of Fed hike in Jul, Sep, Nov at 0% and Dec at 7%.
- However, we think any moves on the dollar is conditional on upcoming FOMC statements and projections. We expect the Fed to acknowledge that recent economic data remains relatively resilient, continues to reiterate gradual and cautious pace of tightening; economic/inflation projection have been revised lower

from previous quarter's projection; but dots plot still signal at least one rate hike this year.

- **Growth and Inflation Outlook**: The third read of **1Q GDP was revised higher to +1.1% saar. (from +0.8%) and slightly higher than consensus of +1.09%.** The economy shows signs of accelerating so far this quarter as the drivers of growth have switched, with consumer spending rebounding while business investment lags behind. While gains in employment and low borrowing costs are helping propel household demand, uncertainty in the wake of Britain's vote to leave the EU is a longer-term risk to already-weak corporate outlays and exports. The advance estimate of second-quarter GDP is scheduled for July 29, when annual revisions will also be issued.

- In the June FOMC, Fed's forecasts for US GDP growth and inflation rate for 2016 were trimmed to 2.0% annual rate (from 2.2% annual rate) and 1.4% YoY from 1.2% YoY respectively, although the unemployment rate forecast remain at 4.7%. The FOMC statement highlighted that the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up. Although the unemployment rate has declined, job gains have diminished. The FOMC currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will strengthen. Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2% over the medium term as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. The next FOMC projections will be released on 22 Sep.

- **US May CPI fell in May.** On m/m terms CPI fell to +0.2% (vs. +0.4% in Apr). On y/y terms, CPI was down to 1.0% (vs. 1.1% in Apr). The rise was led by **medical care, apparel, motor vehicle insurance, and education**. Core inflation increased to 2.2% y/y in May from 2.1%. Fed's preferred measure of inflation – PCE core inflation remains at 1.6% y/y and 0.2% m/m in May. While most survey measures of longer-run inflation expectations show little change, on balance, in recent months, financial market measures of inflation compensation have declined.

- **Monetary Policy Forecast:** At the last FOMC meeting in June, Fed kept the target fed funds rate (FFR) unchanged at 0.25%-0.50% for the fourth consecutive FOMC meeting in June 2016 after the 25bps hike at Dec 2015's FOMC meeting.

- FOMC statement for June meeting (released on 15 June) and Yellen's conference statement suggests that economic growth was relatively weak late last year and early this year. Some of the factors weighing on growth were expected. For example, exports have been soft, reflecting subdued foreign demand and the earlier appreciation of the dollar. Also, activity in the energy sector has obviously been hard hit by the steep drop in oil prices since mid-2014. But the slowdown in other parts of the economy was not expected. In particular, business investment outside of energy was particularly weak during the winter and appears to have remained so into the spring. In addition, growth in household spending slowed noticeably early in the year despite solid increases in household income as well as relatively high levels of consumer sentiment and wealth. Fortunately, the first-quarter slowdown in household spending appears to have been temporary; indicators for the second quarter have so far pointed to a sizable rebound. This recovery is a key factor supporting the Committee's expectation that overall economic activity will expand at a moderate pace over the next few years.

- But now, the labor market appears to have slowed down, but the underlying momentum in the economy has not diminished. Fed will be carefully assessing data on the labor market to make sure that job gains are going to continue at a pace sufficient to result in further improvement in the labor market. The Fed will also be watching the spending data to make sure growth is picking up in line with expectations.
- **Latest Fiscal and External Balance Outlook:** Fiscal sustainability risk continues to weigh on the outlook and may emerge after the Nov 2016 presidential election. In the long term, an improved US economy and manufacturing sector, US shale oil and gas production may improve the US current account leading to dollar support but this is likely to be long drawn and may probably begin only in 2017/2018.
- **Key domestic events and issues to watch in Feb 2015:** Key US events: ISM Manufacturing Mar (1 Jul) (expected: 51.4); Factory Orders (5 Jul); June FOMC minutes release (7 Jul); US Beige Book (14 Jul); US May NFP (8 Jul) (expected: 180k); CPI (15 Jul); GDP 2Q (29 Jul); FOMC decision (28 Jul). Fed Lockhart speaks in Idaho (14 Jul); Fed George speaks in Oklahoma City (15 Jul).
- **Technical Outlook:** Weekly momentum and stochastics indicators suggests a mild bullish bias. But price action suggests upside could be limited at the 200 DMA (now at 96.50 levels). Only a break above that on weekly close basis could see an extension of the rally towards 97.96 (76.4% fibo retracement of 2016 high to low). Support at 95.80 (50% fibo) before 95.20 (100 DMA) and 93.80 (23.6% fibo).

EUR: EU Contagion Risks to Weigh on EUR

Forecast	3Q 2016	4Q2016	1Q 2017	2Q 2017
EUR/USD	**1.0700** (1.1500)	**1.0700** (1.1200)	**1.0600** (1.1100)	**1.0800** (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Post-*Brexit*, odds are rising for ECB to cut rate by another 10bps, but we think it remains too early to tell. We expect ECB to monitor market development, assess impact of the UK-fallout and not take hasty action remain while still adopting an easing bias at the upcoming meeting (21 Jul). To be sure, *Brexit* creates EU contagion risks. It is likely to see more Far Right parties within the Euro-group to call for "Leave EU" referendums. The second order effects of a Brexit on the future of the Euro-club could be further undermined and this could further heighten the level of market volatility and trigger risk-off sentiment in the short term. **EUR could remain under pressure towards 1.07-1.08 levels over the next month or so.** EUR bounces as cautious risk sentiment takes a breather is likely to be shortlived and capped at 1.15 levels.

- We believe the *Brexit* impact can impact Europe via multiple channels including, trade, financial flows, political, sentiment, etc. While it is hard to quantify the impact at this stage, we are **concerned on the political knock-on effects and cautioned that the UK fallout of the Euro-club could potentially trigger EU contagion risk** (especially when Euro-area growth has yet to return back to pre-GFC levels) that is – Far Right parties (i.e. in Spain, Italy, France) calling for "Leave EU" referendums. Already **Netherlands, France and Germany are scheduled to hold elections in Mar, Apr and Aug-Oct 2017, respectively.** These **political events and the risk of "Leave EU" referendums (if held) could undermine the future of the Euro-club, create noises, heighten the level of market uncertainty, and weigh on the EUR.**

- Via the sentiment and financial markets channel, **credit spreads may widen, financial conditions could continue to tighten, and this could put further downside pressure on European banking shares, and put stresses on the funding markets** (we have seen how Portugal, Greece were shut off the funding markets during the European financial crisis). Questions about whether European banks have enough capital will also surface. There is some comfort for now since banks are better capitalized today than before the European debt/ Lehman crisis and there are many liquidity provisions in place.

- In light of EU contagion risk, we revised our EUR forecast over 2H 2016; and keep it further depressed over 1H 2017, taking into account our house view for Fed to tighten in 1H 2017 (policy divergence to weigh on EUR).

- **Growth and Inflation Outlook:** Euro-area 1Q GDP grew faster than expected at 0.6% q/q (vs. 0.5% previous print). On y/y terms, 1Q GDP grew 1.7% (vs. 1.5% previous print). The improvement was due to household consumption. Euro-area industrial sector appears to see a continuation of strong momentum after a strong 1Q. Apr IP rose 1.1% m/m; gains were broad based. Euro-area composite flash PMIs was a touch softer in Jun (52.8 vs. 53.1 in May) due to services PMI (52.4 vs. 53.3 in May) while manufacturing PMI continued to firm (52.6 vs. 51.5 in May).

- While economic recovery in the Euro-area continues, it has yet to recover back to pre-GFC levels. **The *Brexit* impact should cast some uncertainty on Euro-area's recovery.** At least from a trade perspective (UK represents 37% of EU's total trade in 2015) - a number of European countries run trade surpluses with the UK and disruption to trade flow will have an impact of growth prospects for the EU region (but as of now, UK has not triggered the Article-50 and is still paying "membership fees" to EU and remains part of the EU) – we see this as a medium term negative impact.

- **Euro-area inflation is expected to remain near zero or even slip into negative territories.** ECB had expected inflation to recover into later part of 2016, supported by ECB easing measures and economic recovery **but we think the recent UK fallout could potentially delay ECB's hopes of reaching its inflation targets. 5y5y inflation swap fell to its lowest level at 1.257% (27 Jun), from 1.42% (23 Jun).** May headline inflation inched higher 0.4% m/m (vs. 0% in Apr), driven by recreation and culture. Core inflation was steady at +0.8% in May.

- **Monetary Policy Forecast:** Following the *Brexit* event and the uncertainty of the UK exit plans, fear of EU contagion (referendums), we think financial conditions could continue to tighten, credit spreads may widen, and funding markets could be at risk of further stresses. **We expect ECB to respond by providing liquidity measures (TLTRO, OMT) if need arises,** while still keeping monetary conditions accommodative. ECB has promised to take any steps necessary to stabilise financial markets by cooperating with its fellow central banks. **We do not expect additional easing at the next ECB meeting (21 Jul),** given that ECB has only recently expanded its QE program, including the purchase of non-financial corporate debt (credit easing). We do not see a case for further rate cut, or any extension of the duration of its QE program at this meeting as ensuring ample liquidity in the system takes priority while ECB assesses the potential impact before acting.
- At the last ECB meeting (2 Jun), ECB President Draghi said that ECB is willing to take further action if inflation does not pick up, but stressed the need for patience as recently announced QE takes time to see its effect. ECB kept monetary policy status quo - main refi at 0%, marginal lending rate at 0.25% and deposit rate at -0.4%. ECB keep pace of monthly purchase at €80bn per month. Note that this meeting was before the Referendum vote. **We believe that the aftermath of *Brexit* could delay the timeline of ECB reaching its inflation goal.** On ECB purchase of corporate bonds, data from 20 - 24 Jun shows the ECB bought EUR2.7bn of bonds, accelerating its purchase from EUR1.9bn in the first week. Since the program started in Jun, ECB has amassed nearly EUR5bn. **The buying could accelerate further if financial conditions post-*Brexit* worsens.**
- **Latest Fiscal and External Balance Outlook:** The government deficit ratio is projected to decline to 1.5% in 2017, from 2.1% of GDP in 2015. Projected government debt ratio is projected to decline gradually to 88.4% in 2017, from 91.5% of GDP in 2015.
- Euro-area current account surplus widened to EUR27.3bn in Mar from 19.2bn in Feb 2016. Cumulative 12-month current account surplus to GDP as of mar 3.1%, 4-month high.
- **Key domestic events and issues to watch:** Jun CPI (15 Jul); Jul ZEW survey (19 Jul); ECB meeting (21 Jul); Jul Flash PMIs out of Eurozone (22 Jul) and Euro-area Jul confidence data (28 Jul. A handful of Euro-area/Union Finance Ministers are scheduled to meet of 11, 12, 18 Jul in Brussels.
- **Technical Outlook:** EUR traded a range of 1.0910 – 1.1430 in the month of Jun, and is looking on track to end the month slightly on the downside, as we write. Pair was last at 1.1090 levels, below the upward sloping support (formed Dec-2015 to Mar to May-2016 lows). Weekly momentum has turned mild bearish. Next support at 1.1070 (50% fibo retracement of Dec low to May high) before 1.0940 (61.8% fibo), 1.0780 (76.4% fibo). Resistance at 1.12 (38.2% fibo), 1.1360 (23.6% fibo).

GBP: Paralysed by Separation Uncertainty & Politics

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
GBP/USD	1.2500 (1.4800)	1.3000 (1.4800)	1.3000 (1.5200)	1.3500 (-)

Previous Forecast are in parenthesis

- **Motivation for the FX View**: The massive GBP sell-off driven by *Brexit* outcome and rating downgrade has taken place. **Focus next on UK's political development and separation plans which remains highly uncertain**. In the meantime, we expect the **BoE and the Treasury to calm market jitters, provide liquidity measures, ease monetary policy** while the politicians sort out their differences. **BoE meeting (14 Jul) will be one key focus.** On political development, **some clarity could come on 5 Jul when the first balloting for the leadership takes place**. We expect Boris Johnson, Theresa May, Andrea Leasom, Stephen Crabb, Liam Fox, Sajid Javid to be potential candidates. **Greater certainty on the leadership is only expected on 2 Sep but this is no silver bullet as plans on exiting the Euro-club remains unclear.** We expect **GBP to be driven in both directions by political headlines, with bias to the downside as a great deal of uncertainty persists over the next few months.** We adjust GBP lower over our forecast horizon, penciling in another 8-big figures decline to 3Q at 1.25, before seeing a mild rebound into year-end. We list our assumptions in detail below.
- The UK has spoken and they have voted to leave the EU (Leave at 51.9% vs. Remain at 48.1%). Turn- out was larger than expected at 72%. This was an outcome that surprised the markets as well as ourselves (we remain in disbelief), and saw the GBP plunged from above 1.50-handle to a low of 1.32-handle – all in a matter of 7 hours during the announcement of the vote count (24 Jun).
- **What "Uncertainty" are we referring to?** Much uncertainty remains with regards to **negotiation between UK and EU** (on **timing of exit plans, triggering of Article 50 TEU, development of trade relations), domestic politics** on who **(**Boris Johnson, Theresa May, Andrea Leasom, Stephen Crabb, Liam Fox, Sajid Javid**, or some unknown candidate)** takes on the leadership of UK and his/her plans, progress of **UK's bilateral agreements with trade partners,** if **London remains a key financial hub** (as this could affect investment/portfolio/capital inflows especially after being ripped off its triple-A credit rating) and the **fallout impact on investor sentiment, financial stability, growth, jobs, fiscal consolidation plans** (now spending cuts and higher tax rate could be imposed), **inflation** (rapidly declined GBP leading to higher inflation via the import price channel) and **currency** (where is the bottom?), how UK grapples with securing external financing (given lower credit rating and twin deficits).
- **Forecast Changes:** In light of ***Brexit*** (instead of our initial *Bremain* assumption), **negative repercussion** (as highlighted above including who/when the new PM is announced and how soon Article-50 is triggered) that is expected to linger over the next few months, **potential BoE policy response (as early as 14 Jul meeting)** to cut and keep rates lower for longer as the

central bank focuses on prioritising stabilizing sentiment and supporting growth over targeting inflation, we **revised lower our GBP forecasts over the forecast horizon with a low of 1.25 in 3Q before rebounding towards 1.30 end-2016** as dust settles and greater clarity is restored.

- **Assumptions:** We expect UK's new PM to be announced around Sep-Oct 2016. Article-50 (of The European Union "Lisbon" Treaty) to be triggered relatively swift upon the appointment of UK's new PM (before end-2016). We expect UK to leave the EU by early-2019. The key here is to get UK leadership succession in place quick, trigger article-50 promptly, negotiate for EU-UK relationship post-breakup (and not engage in informal discussions as suggested by Michael Dove and Boris Johnson) and strike bilateral relationships with trade partners fast so as to anchor investor/business sentiment – but this could be too smooth sailing to assume, hence our call for downside pressure.
- **Risks to our forecast**: GBP could be in for a longer period of pain – further downside pressure beyond our forecast level and volatile swings in the event of a delay and tussle in the trigger of Article-50. It takes a great deal of leadership and responsibility to trigger and bear the consequences. Also, in the event a second referendum or in the rare event the parliament moves to block the peoples' will, could see GBP swings back up. But we think the occurance of either of the events is very, very low.
- **To Sum Up:** Given so many risk factors, we reiterate again the key drivers that we expect could swings the GBP: 1) who is the new leader; how soon is he/she appointed; and what are his/her plans; 2) timing of trigger of Article-50 – how swift and decisive; 3) exit strategy – how swift trade agreements can be concluded. These will be the key drivers swinging GBP.
- **Short-Term Squeeze Should Not Be Ruled Out:** While we think GBP downside pressure could persist, we caution that GBP-shorts unwinding on profit-taking or over-stretched positioning may see a volatile and equivalent large move to the upside, possibly towards 1.36 or 1.3840 levels (over the next few days) should not be ruled out.
- We shared that our fair value estimate for GBP was at 1.58. The model takes into account yield differentials adjusted for inflation, current account differentials and a reflation variable. We believe that wiith a *Brexit*, the estimate is highly likely to be adjusted lower, which we will review in due course.
- **Growth and Inflation Outlook:** We had previously said that a *Brexit* outcome could adversely affect the UK via various channels including trade, balance of payment (already suffering from twin deficits), investment flows and jobs. This will be a **concern for financial stability and growth, in the next few months.** MNCs/financial institutions could potentially pull out their HQ (from London)/ re-assess investment plans and this could lead to capital outflow or loss of jobs. Trade relations between UK and EU is expected to deteriorate while between the UK and US as well as the rest of the world could also be strained and need to be renegotiated and nobody knows how long the process may take. We expect official growth forecasts to be downgraded in the coming weeks.
- The recent move to downgrade UK's credit rating - 2 notches by S&P and 1 notch by Fitch to AA (negative outlook) could lower the attractiveness of UK as a destination for FDI and portfolio inflows.

This **raises challenges on UK's ability to get external funding/or can continue to fund its current account deficit of -7% of GDP.**

- On inflation outlook, we **expect the large decline in GBP exchange rate to exert upside pressure on prices** (via the import price channel), given UK imports more than it exports. This should erode the purchasing power of the UK consumer and weigh on growth slowdown. Both headline (+0.2% m/m vs. +0.1% prior) and core inflation (+1.2% y/y vs. 1.2% prior) held steady in May.
- **Monetary Policy Forecast:** While UK is very likely to herald in a period of rising prices as a result of the large and rapid drop in GBP, **BoE is almost certain not to tighten rates to curb inflation but to prioritise on supporting growth, calm market jitters and restore financial stability.** BoE Carney's stand prior to the referendum was *"A vote to leave the EU could have material effects on the exchange rate (to depreciate sharply), demand and supply potential," and said that the impact "could possibly include a technical recession. "A vote to leave the EU could have material effects on the exchange rate (to depreciate sharply), demand and supply potential," and said that the impact "could possibly include a technical recession.*
- Rate hike expectation has now been pushed back beyond the foreseeable future. And we expect **low rates to remain lower, for longer.** BoE could cut policy rate (now at 0.5%) as soon as the next meeting (17 Jul) and/or increase asset purchases (QE) to keep monetary conditions accommodative and mitigate the extent of the fallout. Recall that BoE cut rates by 4.5% over 6 months in the aftermath of the Lehman crisis. We also expect BoE to keep liquidity conditions flushed to prevent any occurrence of a Lehman moment. BoE Governor added that he was prepared to inject an additional GBP250bn to ensure FIs did not run out of cash.
- **Latest Fiscal and External Balance Outlook:** UK government's borrowing was slightly higher than expected in May while Apr's borrowing was also revised up by GBP1bn to GBP8.2bn. Recall as of year-end Mar 2016, the government has also missed its forecast by more than initially expected (of about GBP3.8bn).
- The OBR has forecasted that borrowing this financial year to reach GBP55.5bn – a forecast that was revised up in the last Budget from GBP49.9bn. But chancellor Osborne insisted (in March) that the UK was on track to return a budget surplus by 2020. While borrowing might be coming down, although at a slower pace than hoped, debt continues to be on the rise. Public sector net debt (excluding the taxpayer-backed banks) was GBP1.6 trillion at the end of May, equivalent to 83.7 per cent of GDP and a £49.6bn increase year-on-year. With budget deficit already at 4% of GDP, and a Brexit event, fiscal consolidation plans could be in jeopardy.
- UK's 4Q current account deficit widened to record levels of 7% of GDP since data collection began in 1955. This was due to drop in exports and a rise in imports, large increase in primary deficit (lower returns to UK from investment abroad).
- **Key domestic events and issues to watch:** BoE meeting (14 Jul) will be closely watched – if BoE eases monetary policy; Jun CPI, PPI (19 Jul); May labor report (20 Jul); Jun retail sales (21 Jul); 2Q GDP (27 Jul). Watch out for domestic (politically-related) headlines that should come on-stream in Jul-Sep as UK announces its leader to steer UK in its next chapter – potential key dates for

Tory leadership elections – First ballot if more than 3 candidates (5 Jul); new UK PM to be announced (2 Sep).

- Technical Outlook: GBP had a wild day on 24 Jun (referendum result day in Asia) - touching 2016-high of 1.5018 before hitting 2016-low (which is also more than 30 year lows) of 1.3121 – all in a matter of a single daily candlestick chart. As of writing, the pair had rebounded towards the 1.34 levels. The broader trend (weekly and monthly momentum indicators) remains bearish and could see a larger decline. But in the aftermath of the *Brexit* event which saw one of the largest daily swing for GBP (since GFC), we see risk of some technical retracement towards 1.36 – 1.38 levels. Bias to sell rallies. Support at 1.3121 (recent multi-year low), before 1.25.

AUD: The Next Rate Cut Could Come in Aug

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
AUD/USD	**0.72** (0.70)	**0.72** (-)	**0.72** (0.70)	**0.74** (0.70)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** AUDUSD seems unperturbed by its own domestic affairs for much of Jun, leading into the Federal Elections on 2 Jul. Brexit had AUDUSD swing from its 0.76-highs to levels around 0.7350. The pair seems increasingly resilient. After S&P downgraded UK by two notch from its prized AAA rating, there aren't a lot of AAA sovereign bonds left in this uncertain world, especially in the region. Only Singapore and Hong Kong are of AAA grade in Asia. Australia's AAA bonds have likely given the AUDUSD some buffer from the risk-off trades. However, the results of this Sat could reinvigorate AUD bears as a Labor party victory could weaken Australia's fiscal position in the next four years before a projected return to surplus by 2020/21.

- Household consumption continues to be underpinned by strong hiring sentiments, low interest rates, and cheaper oil prices. Over the past few months, cheaper AUD has boosted Australia's tourism and education. Recent rise in commodity price has left the term of trade relatively unchanged. With oil seemingly resilient even in the wake of Brexit, AUD has established tentative support around the 0.7280 (200-DMA). Little direction is seen at this point and we think further rate-cuts may have diminishing returns on cheapening the AUD. It would probably take a downgrade in credit rating for AUD to break the 0.68-support against the USD. Even then, we do not expect pullbacks in the AUD to sustain as quality of Australian bonds are still superior to many other sovereign bonds and potential for future rate cuts could boost the attractiveness of Australian debts. **The events ahead should have AUD swiveling lower around 0.72 for the next six months.**

- **Growth and Inflation Outlook:** 1Q GDP surprised to the upside for Australia, underpinned by stronger-than-expected as non-mining activtity gained traction. Net exports was a key contributor to headline for 1Q, supported by an unexpectedly strong performance of 6.1% (seasonally adjusted) in exports of services. Breakdown by industry shows strong performance by the country's services sector, led by the financial services sector, tourism related services and education while growth of manufacturing remained subdued. Terms of trade likely steadied in Jun as flagged by the commodity index (CRB) which waffled around 410-415 for almost the entire Jun. NAB business conditions rose to 10 from 9 previously while that of business confidence slipped to 3 from 5 ahead of the Federal Elections on 2 Jul.

- May labour report was not well received as all of the jobs addition was part-time hires. The Apr print was revised a lot lower to 0.8K from 10.8K. Jobless rate steadied at 5.7%. The employment prints have been more mixed of late but the Australia Labor Force ANZ Bank Total Job Advertisement spiked 2.4% for May and that could signal an improvement in the labor report for Jun.
- In the meantime, credit growth keeps pace, capacity utilization extends its uptrend its in May, strong tourist arrivals, visitor spending and cheap AUD should continue to support the retail sales and household consumption to some extent.
- The Brexit event triggered a rather shallow sell-off in the AUD considering the event risk as AUD moved with the more resilient Asian currencies. However, the jump in 5Y CDS of major Australian banks in tandem with investment grade European corporate entities measured by the Markit iTraxx Europe index suggests that domestic banks could be impacted should credit confidence deteriorate in Europe.
- **Monetary Policy Forecast:** RBA kept rates unchanged in Jun and left out the explicit easing bias that everyone was looking for in its statement. The rather neutral statement lifted the AUDUSD and the pair has been rather resilient ever since. In the last monthly, we had highlighted risk of another rate cut in Aug as we expect 2Q inflation to remain subdued. We continue to see risks of RBA doing so as a cheap AUD is key to supporting the non-mining sector growth. Assuming no negative rating action after the election on 2 Jul, the return to hunt for yield or even flight to quality will strengthen the AUD and complicate the economic rebalancing towards the non-mining sectors.
- **Apart from the AUD strength, RBA watches the non-mining sector performance and wholesale funding costs for Australian banks.** We see upside risks to the wholesale funding costs of Australian bank because of two events - further escalation in EU contagion from the Brexit event and a AAA rating downgrade. In the event of a victory by the Australian Labor Party, the country's AAA sovereign rating could be at risk and even if Labor's budget is more expansionary for the economy, a spike in funding cost owed to a rating downgrade would force RBA to move in Aug. Even without such an acute event risk, the unravelling of UK's exit from the EU could weigh on risk appetite and drive up wholesale funding cost for Australian banks. A rise in wholesale funding costs translate to higher lending rates that could crimp on corporate investment decisions and household consumption. Downside growth risks are thus likely to trigger the next cut **in Aug.**
- The **rate cut** in May was a pre-emptive move but further moves to weaken the AUD is likely to have diminishing returns. Timing

is crucial and we see the next cut likely in Aug as development in the EU and impact on the funding costs for Australia would be more apparent then. Risk to our view for a rate cut then is the exhuberent residential credit growth rebound and rise in property prices in Sydney.

- **Latest Fiscal and External Balance Outlook:** The budget bottom line for the next four years is now dependent on the Federal elections on 2 Jul. The Labor party has decided to increase the deficit by $16.4bn over the next four years though projects to return to surplus at the same time as the Coaltion by the 2020-21 financial year. On the other hand, the Coaliton has announced plans to improve welfare payment that would supposedly save more than $2bn and lift the budget bottom line by over $1bn from the budget released in May.
- To recall, **t**he budget deficit presented in May for 2016 is expected to be A$37bn. The deficit is projected to exist for the next four years. The government expects to raise tax on tobacco and commit a record A$50bn in infrastructure investment between 2013-14 and 2019-20 for roads, rail, airports and dams. Fiscal deficit is estimated to be around -2.2% of GDP for 2016-2017 before gradually narrowing towards -0.1% by 2019-20. Real GDP is estimated to be 2.5% this year before accelerating to 3% for the next 3 subsequent fiscal years. One of the key plans is the Ten Year Enterprise Tax Plan meant to boost new investment, create and support jobs ad increase real wages. The Plan will see lower tax rates for small businesses first before progressively extending cuts to all companies by 2026-27. For personal tax, the government will also lift the tax threshold on the middle tax bracket to prevent average full time wage earners from moving into the second top tax bracket. This could serve to boost consumption in the long run.
- Current account deficit narrowed slightly to -A$20.8bn in 1Q from previous –A$22.6bn in 4Q (last available data). The improvement was due to narrower dedicit in the goods and services with services posting narrowest deficit since 4Q 2014.
- **Key domestic events and issues to watch: Federal elections** is scheduled on the 2nd of Jul. Jun inflation estimates is due on the 4th. **RBA decides on cash target rate on the 5th** along with the release of trade bal for May and retail sales. Home loans for May is due on the 11th. **NAB business surveys** for Jun will be released on the 12th before Jun labour report on the 14th. Minutes of the May meeting is due on the 19th. **2Q CPI is due on the 27th - should have some implications for potential rate action in Aug.**
- **Technical Outlook:** Daily chart shows MACD returning to the zero-line and stochastics overbought. Weekly chart indicates range-plays within 0.68-0.78 at this point and risks are to the downside, guided by the 100-WMA at 0.7738. Pullbacks to meet support at 0.7064 first before our eventual target at 0.68. Should that level hold, we anticipate a strong double bottom.

NZD: Cautiously Supported on Yield Differentials

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
NZD/USD	0.6850 (0.6600)	0.7000 (0.6700)	0.6900 (0.6650)	0.7200 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Kiwi continued to drift higher above the 0.70-handle as a result of improvement in risk appetite (prior to *Brexit*) and widening yield differentials between NZ and rest of the world (favouring the NZD). This is despite bearish macro-fundamentals (benign inflation outlook, challenging dairy sector, etc.). We think the drift higher could still continue as yield differentials continue to favor NZD. Other factors – sentiment, rate cut expectation may perhaps act to tamper Kiwi gains.

- We think the *Brexit* event is only likely to cause little direct impact on NZD, as compared to other currencies (i.e. EUR). From a goods & services trade perspective, NZ's share of exports to UK stood at 3.7% of total exports while imports stood at 2.5% of total imports (as of 2015). UK is only the number 6th trading partner of NZ (representing 3.15% of total trade). YTD, on an exchange rate beta perspective, NZD continues to trade GBP with 0.04 beta (log values), with correlation coefficient at insiginificant levels of +0.06 (out of maximum of +1 or -1). To give a comparison, NZD trades AUD with a 0.91 beta, and at correlation coefficient of +0.74.

- But that does not mean NZD will escape unscathed from *Brexit*. Persistent stresses on UK (as a result of uncertainty arising from *Brexit* on UK – exit plans, UK leadership, when to trigger Article 50) could still weigh on global sentiment and heighten the level of uncertainty and volatility, and this could still weigh on sentiment and on the Kiwi (via sentiment effect) and rate cut expectation. And we think over the next few months, negative repercussion as a result of uncertainty in UK could weigh on sentiment and on NZD. Other factors that could weigh on sentiment is the rate cut expectation. In light of *Brexit* fallout, the markets-implied probability of rate cut at the next meeting in Aug has risen to 65%, from 35% (23 Jun before Referendum results). We think the likelihood may have risen for a cut but prefer to wait for further data (2Q CPI data on 18 Jul) and assess financial market conditions before making a case. The introduction of macro-prudential measures including loan-to-value ratios revisions for investors is also expected to have a second order effect of weighing on the NZD (via limiting foreign purchase of properties) but question remains when will RBNZ introduce. We are not expecting RBNZ to introduce in the coming month. Earliest could be some time in 4Q.

- Given the above bearish factors and our house view assumption of deferred Fed rate hike to 1H 2017, we think USD could remain better bid on dips (due to risk aversion rather than rate hike expectation) and that should mitigate some of NZD's strength (due to widening yield differentials in favor of NZD). We expect NZD to trade 0.68 – 0.73 range over the course of next month.

- We calibrated our NZD forecast slightly higher, in light of yield differentials in support of NZD but still keep our 3Q 2016 – 1Q 2017 NZD forecast below current spot to take into consideration the potential risk aversion environment which could weigh on sentiment and on the NZD.

- **Growth and Inflation Outlook:** 1Q GDP came in stronger than expected at +0.7% q/q but was slightly weaker on sequential terms as compared to previous quarter (+0.9%). On y/y terms, GDP expanded +2.8% (vs. 2.3% in 4Q 2014). Growth was underpinned by construction, tourism and healthcare services but partially offset by primary industries (including oil/gas extraction, coal mining) as well as manufacturing.

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

- **Monetary Policy Forecast:** At the last RBNZ MPC meeting on 9 Jun, RBNZ kept OCR unchanged at 2.25%. Accompanying statement was less dovish than previous MPS. RBNZ explained that the recent appreciation in the NZD was a reflection of improvement in risk appetite and widening yield differentials. RBNZ Governor's speech suggested that further rate cut may not have the intended effect to weigh on NZD as NZD TWI has crawled back up to where it was before RBNZ began easing in Jun 2015. He added that RBNZ still has room to cut rates and will not hesitate to do so, if need be.

- In light of *Brexit* fallout, the markets-implied probability of rate cut at the next meeting in Aug has risen to 65%, from 35% (23 Jun before Referendum results). We think the likelihood may have risen for a cut but prefer to wait for further data (2Q CPI data on 18 Jul) and assess financial market conditions before making a case. We expect RBNZ to introduce macro-prudential measures including further loan-to-value ratios revisions for investors in the next few months.

- **In** the Financial Stability Report May 2016, RBNZ noted that imbalances in the housing market continue to increase, contributing to financial stability risk. While restrictions on loan-to-value ratios or LVRs (introduced in Nov-2015) and government tax measures (introduced in Oct 2015) have cooled the housing market into early-2016, Auckland housing prices remain stretched relative to income and recent data suggest prices pressures are coming back. In Governor Wheeler's speech to the Parliament Select Committee (9 Jun), he said investors accounted for 46% of property transaction in Auckland and about 40% for the rest of the regions, and RBNZ is working on further macro-prudential measures which could come in the form debt to income ratios and/or expand the existing loan-to-value for investors. The latter should be introduced sometime before the end of 2016 while the former might not be implemented so soon. We believe further implementation of macro-prudential measures, especially on investors could have the second order effect of weighing on the NZD (via limiting foreign purchase of properties).

- **Latest Fiscal and External Balance Outlook:** 1Q current account swung into surplus of NZ$1.3bn from deficit of -NZD2.61bn (in 4Q). 1Q 2016 current account deficit stood at 3.0% of GDP (an improvement from -3.1%). This was due to an increase in the services surplus (helped by tourism) and a decrease in the primary income deficit

- In NZ budget announcement (26 May), the Treasury reported budget surplus of NZD668m (vs. NZD401m deficit). Budget surplus for the following 2 years have also been raised due to higher tax revenue and lower expenses. Treasury is forecasting GDP growth of 2.9% in 2016, 3.3% in 2017 and 3% in 2018. As a result of better than expected budget, the planned bond issuance for 2017-17 has been lowered to NZD7bn (from NZD9bn).
- **Key domestic events and issues to watch:** Jun PMI (14 Jul); 2Q CPI (18 Jul); Jun trade (26 Jun). GDT auction on 6 and 20 Jul.
- **Technical Outlook:** For the month of Jun, NZD drifted as high as 0.73 before the surprise *Brexit* outcome, which saw a pullback towards 0.7080 levels, at time of writing. Daily momentum suggests a further pullback. Next support at 0.7030 (21 DMA), 0.6910 (50 DMA) before 0.6840 (100 DMA). Resistance at 0.7160 (61.8% fibo retracement of 2015 high to low) before 0.7390 (76.4% fibo).

JPY: Imminent BOJ Moves

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDJPY	104 (114)	106 (116)	107 (120)	109 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The UK decision to leave the EU has almost single-handedly unwound the gains in the USDJPY since Abenomics began in 2013. While this is somewhat of an exaggeration, the impact of Brexit on the USDJPY cannot be underestimated. Since the results of the UK referendum, the flight to safe-havens sent the JPY higher by nearly 4.0% against the USD, adding to the 15.2% gain so far this year. At one point on 24 Jun, the USDJPY breached briefly the 100-level to 99.02 before rebounding back towards the 102-levels. The JPY remains under upside pressure as safe-haven flows continues. Nevertheless, further upside could be capped by increasing expectations that the government will intervene to prevent the JPY from strengthening further and for the BOJ to add to its easing measures.
- Despite jawboning by the government and BOJ, investors continue to add to their long-JPY bets in vote against Abenomics. This has weighed on the USDJPY. Investors purchased more than 50000 contracts in the weeks of 14 and 21 Jun after such bets were pared to around 14800 contracts in the week of 31 May. Meanwhile, foreign investors sold off JPY0.1tn in equities in the first two weeks of Jun (latest data available) but purchased JPY0.3tn in government debt. At the same time, Japanese investors bought JPY0.2tn and JPY0.4tn in overseas equities and government debt and is likely to have hedged against possible JPY strength. The actions of both foreign and domestic investors

have thus dragged the USDJPY lower. All of these suggest that confidence in Abenomics among investors remains subdued.

- We continue to expect the BOJ to add to its already ultra-loose monetary policy at its 28-29 Jul meeting. But an emergency meeting before the scheduled meeting dates cannot be ruled if the JPY consistently slips below the key 100-level and puts its 2% inflation target under threat. Measures we expect the BOJ to take includes extension of the base money, purchasing more ETFs and cutting interest rate further. As well, the central bank could also introduced negative lending rate to encourage banks to lend or a tax on corporate profit to prevent cash hoarding, though these appear unlikely for now. As a last resort, the BOJ could also introduce 'helicopter money', that is financing government debt directly, but which faces additional hurdle of requiring legislation changes. Until then, further jawboning can be expected from the government and BOJ in an attempt to limit downsides to the pair.

- However, the capping the USDJPY rise amid a BOJ move, even possibly a larger-than-expected supplementary budget of more than JPY10tn and dollar strength, is the underwhelming confidence in Abenomics. The risk ahead remains the rising concern of the efficacy of the policies of Abenomics, putting PM Abe's and BOJ governor Kuroda's credibility at risk should the economy fail to reflate. The collapse in confidence could trigger a sell-off in the Nikkei and force large unwinds of long-JPY positions and risks the USDJPY falling back below the 100-levels. Thus, we need to see renewed confidence in Abenomices being rebuild for the BOJ moves to have their desired effect. The danger though is that a big win by PM Abe in the Upper House election could result in a push towards security issues and constitutional changes than on the Third Arrow of Abenomics of liberalization and structural reforms, including changes to immigration rules and labour market. The failure to act would be a wasted opportunity to push the economy out of deflation and on the road to recovery.

- Given the market development so far and the risks of Brexit encouraging further safe-haven flows into the JPY and unless of see renewed confidence in Abenomics, we now expect the USDJPY to end 3Q at 105 even as BOJ unleashes another round of monetary easing in Jul. Thereafter, we expect the pair to continue its climb higher, aided by dollar strength, to 108 to end the year. Going into 2017, expectations of a US Fed fund rate hike in Mar (our house view) should help lift the pair higher to 110 and 112 by end-1Q and -2Q 2017 respectively.

- **Growth and Inflation Outlook:** The outlook for the economy remains mixed even as the economy avoided a technical recession in 1Q 2016. Final print for 1Q 2016 showed the economy rising by 1.9% annualized seasonally-adjusted q/q, up from the preliminary 1.7%. Contributing to the better-than-expected growth was a recovery in net exports, a rise in public spending and the leap year's effect on consumption. Investment spending however declined, suggesting that growth in 2Q could be weak. Industrial production slipped 3.3% y/y in Apr, while core machinery orders – orders that exclude volatile orders for ships and power equipment – fell 7.1% y/y. The external economy could not mitigate the weaknesses domestically with exports contracting by 11.3% y/y in May from 10.1% in Apr. On the flip-side, all industry activity index rose 1.3% m/m in Apr from 0.2% in Mar. Still, with the outlook for 2Q and beyond looking stretched, more fiscal spending could be in the offering. There are plans by the Abe government to launch a supplementary budget totaling around JPY5-10tn to support the economy.

- Inflation is likely to remain on the slide in May. Market expects headline inflation to fall by a larger 0.5% y/y in May from 0.3% in Apr. Core inflation (CPI less fresh food) is expected to dip by -0.4% y/y in May, slightly larger than Apr's 0.3% y/y (Mar: 0.3%). The favoured inflation gauge of the BOJ – the core core inflation which is headline inflation less fresh food and energy prices - slipped slightly to print +0.9% y/y in Apr after rising by 1.1% for the past three months. This should be worrisome for the BOJ as its 2% inflation target remains a way off. It also did not help that labour cash earnings saw flat growth, stifling efforts by the BOJ to spur inflationary pressures. Despite the weak performances so far, the BOJ continues to expect core inflation to average 0.5% in FY 2016-17, 1.7% in FY2017-18, and to 1.9% in FY 2018-19.
- **Monetary Policy Forecast:** After holding off adding to its existing suites of measures, the BOJ is likely to ease policy further at its 28-29 Jul meeting. We continue to expect the central bank move only after the Upper House elections in 10 Jul as it would likely want to avoid being embroiled in any political entanglement during the campaigning period. Any further action by the BOJ cannot be piecemeal as seen when the NIRP was introduced. We expect the BOJ to introduce a comprehensive suite of measures including expanding the monetary base to JPY100tn from JPY80tn currently, increasing the purchase of ETFs to JPY10tn from JPY3tn and cutting interest rate further to -0.3%. Other possible measures that could be used include a tax on corporate profits to induce companies to spend rather than hoard cash and even possible negative lending rates, though the probability of these measures being introduced now is low. Helicopter money – i.e. the BOJ directly financing the government's budget deficit – is unlikely for now, though using this option would require legislative changes. But we believe this 'nuclear option' could still be used as a last resort should other measures fail to reflate the economy. This of course does not preclude the BOJ from meeting in emergency session before the scheduled meeting should the USDJPY slips persistently below the 100-levels and puts its 2% inflation under threat.
- **Latest Fiscal and External Balance Outlook:** As widely expected, PM Abe delayed the introduction of the next phase of the consumption sales tax hike that should take effect in Apr 2017. Instead the tax hike to 10% from 8% will be postponed by two-and-half years to Oct 2019. This move could likely remove a possible trigger for a recession like the one that hit the economy when the tax was raised in 2014. It would also allow more time for the government to introduce policies that would strengthen the economy to withstand an increase in the consumption tax. Details of these policies however remain scarce. Market is speculating that the government is likely to propose a stimulus package of JPY5-10tn after the Upper House election, but even more could be proposed if global growth tanks and the JPY appreciation persist. This decision puts to doubt the government's plans for fiscal consolidation. It increases the risks that the debt burden could climb even higher towards two-and-a-half times the size of the economy. Also, it removes a source of funding for the social security system.
- The current account surplus narrowed in Apr to JPY1.88tn in Apr after ballooning to JPY2.98tn in Mar. The narrower surplus could be attributed to a smaller surplus in the goods and services

account of JPY0.30tn (Mar: JPY1.17tn) and primary account of JPY1.78tn (Mar: JPY2.13tn). Similarly, the financial account narrowed to JPY1.48tn in Apr from JPY5.36tn in Mar due to a portfolio investment outflow of JPY5.30tn (Mar; +JPY9.41tn) that offset the surplus in the other investment segment of JPY6.24 tn. This together with smaller current account surplus resulted in a much narrower overall balance of payments of JPY2.96tn in Apr compared to JPY10.71tn in Mar.

- **Key domestic events and issues to watch**: On the political front, Japan heads to the poll to elect half of the members of the Upper House on 10 Jul. On the economic front, the BOJ's Tankan Survey results for 2Q will be released on 1 Jul. BOJ governor Kuroda speaks on 7 Jul at the Branch Managers' Meeting and the BOJ meets on 29 Jul to decide on policy. JGB auctions in Jul: 10-year (5 Jul), 30-year (12 Jul), 5-year (14 Jul), 1-year (15 Jul) and 20-year (20 Jul).

- **Technical Outlook:** USDJPY plunged beyond 100-level to trade a low of 99.02 (24 Jun) before rebounding. Last seen at 102.60 levels at time of writing. Weekly and daily stochastics are near oversold conditions. Risk of technical rebound cannot be ruled out. Resistance at 105.55 levels (21 DMA), 106.90 (38.2% fibo retracement of 2012 low to 2015 high). Support remains at 101 (50% fibo) before 95 (61.8% fibo).

CNY: How To Get To A More Market Determined CNY

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/CNY	**6.65** (6.50)	**6.67** (6.55)	**6.70** (6.57)	**6.70** (-)
USDCNH	**6.67** (6.50)	**6.69** (6.57)	**6.71** (6.60)	**6.70** (-)

No Change From Previous Forecast

- **Motivation for the FX View:** Risk-off post-Brexit lifted USDAXJs, including USDCNH before PBOC intervened to curb the weakness in the offshore yuan. Yuan weakness seems to persist as market players continue to remain cautious of China's growth outlook and intervention in the forex markets have not been drastic. As USDCNY make its retreat, the CFETS TWI also weakened, suggesting that the officials want to allow further depreciation of the yuan against its trading partners. We think the 6.70-level is now much closer than before and we continue to see more upside for USDCNH as flights to traditional safe haven USD exacerbate bearish sentiments on the yuan against the dollar. With PBOC still eyeing the overaching goal of getting its bonds and equtiies included in global bonds and equity indexes, we think PBOC is making use of risk events to release depreciation pressure on the CNY while they carry out economic reforms. A more market-market determined yuan would make room for capital account liberalization and eventual inclusion in global indices. We do not expect another one-off devaluation. With a strong current account surplus, there is a reasonable buffer for CNY weakness against the USD.

- In addition, potential inclusion of the more volatile KRW and ZAR into the CFETS TWI could mean more volatile CNY against the USD. Taken together with risks of more downside pressure from further monetary easing, we have revised our USDCNY forecast higher towards 6.80 by 1Q of next year.

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

- In the near-term, industrial profits saw modest growth of 3.7%y/y in May, softening fro previous 4.2%. We also see that 60% of industrial profits are now made up of non-overcapacity sectors. Growth trajectory is still L-shaped, as widely acknowledged by top officials. We do not see a strong rebound in economic indicators in the near-term.

- **Our monthly Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) showed the score for China steadied at 4.7 (with 1 being the best and 9 being the worst).

- **Growth and inflation outlook:** China is still focused on achieving growth stability, yuan stability and deleveraging with stability. Growth outlook is still fragile. May PMI-mfg came in at 50.1 vs previous 50.1. Non-mfg also came in at 53.1 vs. previous 53.5. The Caixin version was also lower at 49.2 vs. previous 49.4. Growth of exports slowed to 1.2%y/y in May from 4.1% previously. Imports had a mild contraction of -0.4%y/y compared to Apr's -10.9%. Trade balance widened to CNY324.8bn from previous CNY298.00bn.

- Inflation steadied softened to 2.0%y/y for May from previous -2.3% as food costs slowed to 5.9%y/y from previous 7.4%. PPI showed less contraction by -3.4%y/y from previous -4.3%. Industrial production steadied at 6.0%y/y in May and retail salees slowed a tad to 10.0%y/y from previous 10.1%. The headline-grabbing release was the urban FAI that decelerated to just 9.6%y/y from previous 10.5%. The officials have pinned it to a drop in investment in sectors that suffer from overcapacity. Industrial profitability has dwindled to flat in May for both overcapacity and non-capacity sectors. That has raised calls for RRR cut for much of the second quarter.

- **We continue to expect liquidity support for the old and new economies in China**. Home mortgage loans continued to rise in 1Q on the back of easy monetary conditions. Macro prudential measures should remain in place in the tier-one cities. The growth in the real estate sector should continue to have positive spillover effects in mining, construction, consumer goods and real estate services.

- **Monetary Policy: While we think that the case for a RRR cut or interest rate cut have increased,** we continue to expect PBOC to use adhoc measures like pledged supplementary lending, medium term lending facility and standing lending facility to supply credit to the targeted sectors that require more liquidity support. Broad based RRR cuts may risk generating flows to assets that are prone to bubbles (real estate in the tier-one property sectors), undoing deleveraging efforts in the economy and increase downside pressure on the CNY.

- For the month of May, PBOC injected CNY570mn via 1-day SLF, CNY175bn of 3M MLF and CNY115bn for 6M MLF. The central bank also injected a net CNY290bn of liquidity via open market operations. In total, PBOC has injected CNY580.57bn of liquidity for May. Expect more liquidity injections in Jun.

- **Liquidity management is still key and with a significant number of default cases**, the 5yr CDS is elevated at around 120, compared to historical average of around 100. 7-day repo rate remained at around 2.36% while 3M-SHIBOR has surged 2.96% from a low of 2.79% in Mar. We continue to expect PBOC to rely more on targeted liquidity measures such as open market operations, standing lending facility (SLF), medium term lending facility (MLF), pledged supplementary lending (PSL). We continue to look for 100bps in the next half of the year.

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

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

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

- **Key domestic events and issues to watch:** Jun PMI-mfg and non-mfg are due on 1 Jul along with Caixin PMI-mfg. Foreign reserves is scheduled for release on the 7th. CPI and PPI on the 10th. Liquidity prints are due anytime from Jun trade is due on the

13th. Liquidity numbers are due from 10th-15th. Activity data is due on 15th along with 2Q GDP. We also like to watch Jun industrial profits due on the 27th. We would not rule out potential inclusion into MSCI and other global bond indices.

- **Technical Outlook:** USDCNH was last seen around 6.6580, on its way to revist the 6.7620. Bullish momentum is increasing and stochastics shows signs of turning higher from oversold levels. Uptrend seems adamant hold. Retraecments likely shallow with support around 6.5980.

KRW: Supported on Dips

Forecast	3Q 2016	4Q2016	1Q 2017	2Q 2017
USD/KRW	1185 (1167)	1170 (-)	1180 (-)	1180 (-)

No Change from Previous Forecast

- **Motivation for the FX View:** The government's effort to push through corporate restructuring (as announced 8 Jun) is a medium term positive but a short term pain (job cuts, negative impact on growth). Fiscal stimulus support (announced 28 Jun) is expected to cushion some of the negative impact. Putting together the domestic short term pain, increased likelihood of further BoK rate cut and potential cautious risk sentiement arising out of *Brexit*-induced uncertainty, and our house view for deferred Fed rate hike, we think USDKRW could remain supported on dips.
- We expect the negative repercussion arising out of the UK fallout to persist especially when a great deal of uncertainty remains and worries of EU contagion (potential more "Leave EU referendums) could well keep risk sentiment cautious. This could also put on pressure for BoK to do more via easing. Already, BoK was said to provide more than KRW3tn short term liquidity in the week post-EU referendum by flexibly managing open market operations.
- While pushing through corporate restructuring plan is a good initiative (seen as medium term positive), we see some pain in the short term as jobs (in the shipping and banking sectors) will go, businesses will be rationalized and these will impact economic growth to the downside. Bear in mind Korea is already suffering from an extended slowdown in exports and investment resulting in prolonged periods of low growth and low employment.
- To mitigate some of these impact and in response to *Brexit*-driven heightened uncertainty, the Korea government has announced (28 Jun) more than KRW20tn worth of fiscal stimulus including KRW10tn of extra budget (worth 0.6% of GDP) while the other KRW10tn is used to recapitalize banks. Fiscal stimulus will be used to support jobs, growth which face downside risks from *Brexit* and corporate restructuring. We also expect BoK to keep rates low for longer, with a bias to additional rate cut.

- Taking into consideration some short term restructuring pains at home, rising likelihood of BoK rate cut and cautious risk sentiment (due to UK uncertainty US elections in Nov), we revised our USDKRW forecast higher for 3Q 2016. But we keep 4Q forecast below 3Q, as uncertainty slowly subsides. 1H 2017 USDKRW forecasts are higher than 4Q 2016 due to expectation of rate hike (USD supportive in the lead up to Fed rate hike).

- But over the next 1-2 weeks, we see a good chance of some unwinding of USDKRW-longs, given the big 50-won run-up in the pair on the *Brexit*-driven risk-off event. We see support around 1150 levels.

- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for S.Korea worsened to 6.6 (from 6.4 in May). The deterioration was due to fiscal.

- **Growth and Inflation Outlook:** 1Q GDP expanded +0.5% q/q; +2.8% y/y, better than previous estimates of +0.4% q/q and +2.7% y/y. While manufacturing PMI improved slightly in May (50.1 vs. 50 in Apr), IP continue to fall in Apr although by a smaller magnitude (-1.3% m/m vs. +2.2% in Mar). Exports also fell in May (-6% y/y vs. -11.2% in Apr) but by a smaller magnitude as well.

- BoK had earlier lowered 2016 GDP growth to 2.8% (from 3%) and inflation forecast to 1.2% (from 1.4%), due to weaker than expected domestic economic growth in 1Q 2016 and downward revision to global economic growth. We retain our bearish bias on the economy against a backdrop of ongoing sluggish external demand (17 consecutive months of decline), rising risks of slowing recovery in domestic demand, benign inflation outlook and ongoing geopolitical tension.

- **May headline and core inflation slowed on y/y terms.** Headline CPI slowed to 0.8% vs. 1% in Apr while core CPI slowed to 1.6% (vs. 1.8% in Apr). Core inflation was at its lowest print since dec 2014. On sequential basis, headline inflation was zero (down from 0.1% prior) due to food, non-alcohol beverages, housing and utilities.

- **Monetary Policy Forecast:** BoK cut rate by 25bps to record low of 1.25% (9 Jun). This was a surprise move to markets as well as us. We had expected BoK to keep rate on hold and only cut rate if supported by fiscal stimulus and structural reform.

- Indeed there was **decision on BoK and the government (8 Jun) to agree to set up KRW11tn corporate restructuring fund** to support state-run banks (Korea Development Bank and Korea Export-Import Bank) that will lead the restructuring of shipping companies and shipbuilders. The government estimated that the 2 banks need between KRW 5 – 8tn to keep capital adequacy ratios in line with BASEL III standards. The contribution towards the KRW11tn fund (to be managed by by Korea Asset Management Corp) will come from the BoK (KRW10tn and guaranteed by the governement) and Industrial Bank of Korea (KRW1tn). The **fund will purchase contingent convertible bonds of KDB and Eximbank to raise their respective BIS ratios** (a gauge for adequacy capital). Note that BoK contribution comes via loan instead of QE (which was previously suggested by the government). In terms of corporate restructuring for KDB and Eximbank, salary and jobs will be cut. In terms of the restructuring of shipping companies and shipbuilders, the plan includes selling off assets, job cuts and business restructuring.

Government is also preparing measures to support those losing employment. Tthe Korea government has announced (28 Jun) more than KRW20tn worth of fiscal stimulus including KRW10tn of extra budget (worth 0.6% of GDP) to cushion the negative impact from corporate restructuring and to mitigate effects arising out of *Brexit*-induced risks.

- The government also announced revisions to macro-pruidential FX regulation (effective 1 Jul). 1) cap on Korean banks' FX forward positions will be raised to 40% (from 30%) and cap for foreign banks will be raised to 200% (from 150%) – to allow for banks to have more short-term foreign denominated borrowing (to induce foreign currency inflows); 2) FX liquidity coverage ratio (LCR) will become mandatory and will rise 10 ppt each year until it reaches 80% in 2019, in line with BASEL III guidelines (note most banks' LCR already exceed 100%). The commercial banks are required to hold high-quality liquid assets including cash, FX reserves and high grade bonds equivalent to at least 60% (which will rise by 10 ppts each year) of their estimated monthly FX outflows – to give banks the means to secure short term FX liquidity to prevent for any severe outflows; 3) Temporary revision to legislation on FX transactions, lowering the macrostability levy on financial institutions – in an attempt to forestall severe capital outflows.
- At the last MPC meeting (9 Jun), BoK said the decision to cut rate was unanimous and was due to growth path weaker than expected and inflation to remain below 2% for some time. BoK Governor Lee stressed data dependency with regards to future rate decision (leaving the door open for possible and further rate cuts). When asked about effective floor on policy rate, he said that the cut would bring the policy rate closer to the limit but it does not mean there is no room for further rate cut. With that, another 25bps cut in 3Q should not be rule out should growth, inflation indicators refuse to pick up. Bear in mind that we had noted that the new BoK MPC committee is dovish-inclined.
- **Latest Fiscal and External Balance Outlook:** Current account surplus narrowed further to $3.37bn in Apr, from $10.1bn in Mar due to widening deficit in the services sector and narrowing of goods account surplus. While current account surplus may be the lowest level in more than 2 years, Korea has posted its longest monthly current account surplus for 50 months.
- According to the Public Finance 2015 report issued by National Assembly Budget Office, fiscal deficit for 2016 is expected to widened to -2.3% of GDP. Sovereign debt to GDP is expected to climb to 40% of GDP for 2016.
- **Key domestic events and issues to watch:** S. Korea releases Jun exports and CPI inflation (1 Jul); BoK meets (14 Jul); 2Q prelim GDP (26 Jul) and Jun IP (29 Jul).
- **Technical Outlook:** USDKRW had a choppy month before ending Jun lower at 1152 levels. Weekly and daily momentum indicators are showing signs of turning mild bearish. Support at 1142 (upward sloping trend line support from the low of Sep 2014 to Apr 2016). Break below targets 1125 (2016 lows). Resistance at 1171 (38.2% fibo retracement of 2016 high to low) before 1185 (50% fibo).

SGD: Still Bearish Bias

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/SGD	1.3750 (1.3850)	1.3850 (1.3900)	1.3900 (1.3950)	1.4000 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USDSGD slide lower for most of Jun came to an end when the UK voted to leave the EU on 24 Jun. The turmoil in the markets that followed sent the USDSGD to **1.3722** - a high not seen since the beginning of Jun. Year-to-date, the pair has climbed around 4.3% against the USD, helped by dissipating concerns of a Fed fund rate hike this year. This was also despite the surprise shift in policy to neutral by MAS at its Apr meeting. Until the dust from Brexit settles, the USDSGD should remain under upside pressure ahead.
- The SGD remains weighed by domestic and external challenges. Domestically, the economy is underperforming due to ongoing economic restructuring, shifting away from a reliance on foreign workers towards more productivity-driven growth. Reinforcing the domestic challenges are external headwinds, including the sluggish global growth outlook amid a restructuring China and, now, Brexit, that could soften risk appetite, especially for riskier assets like equities, and lead to greater volatility in the FX markets and weigh on the SGD. Even the strong persistent balance of payments surpluses are unlikely to keep the USDSGD from heading higher towards the 1.39-levels by end-2016 from its current levels around 1.35-region, but could moderate the rise in the pair.
- These challenges are manifested in Moody's recent downgrade of the Singapore banking system's outlook to negative. According to Moody's, this change reflected "the weaker operating environment for the banks, against the backdrop of softer domestic and regional economic and trade growth". In addition, Moody's is concern about the banks' asset quality and profitability given their high exposure to energy-related industries and generally high leverage of domestic firms. The Moody's outlook downgrade of the banking sector's is a reflection of the weaknesses in the domestic economy amid a challenging global environment and reinforces the potential downside risks to the SGD ahead. However, the banking system downgrade by Moody's we feel have limited impact now.
- Despite its quasi-safe haven status as the only triple-A rated economy in Asia, the Brexit vote sent the USDSGD reeling as investors re-positioned and longed the USDSGD once again. This was reinforced by foreign and domestic investors unloading Singapore equities as reflected in the 2.3% drop in the stock index between 24-27 Jun. Mitigating these outflows has been the likely purchased of Singapore government bonds by foreign investors as a hedge against the uncertainty in the global markets. Yields for government debt were lower by 0.5-7.6bp across all tenors except for the 1M and 3M in the aftermath of the Brexit vote. Month-to date, government bond yields have fallen

by 4.85-39.28bp across all tenors. Thus, the climb in the USDSGD has not been as aggressive as a result following the Brexit vote.

- Our house view is now for US Fed to hold its fund rate steady in 2016 and to normalize rate again in 1H 2017. Nevertheless, we continue to expect dollar strength to remain intact due to global risk aversion that could send investors fleeing to safe-havens including the USD and JPY from riskier assets. This together with the lift USDJPY upmoves back towards the 110-handle by the end of the year and beyond (there is a positive correlation with the USDSGD), should lift the USDSGD higher. In addition, a relatively stronger MYR as a result of firmer global oil prices and stable domestic political environment could push the SGDMYR lower and put downward pressure on the SGD.
- Thus a combination of external influences and domestic factors should keep the USDSGD elevated for the rest of the 2016 and into 1H 2017 at least. We expect the pair to end 3Q-2016 at 1.3750 before ending the year at 1.3850. The pair should continue on its climb higher in 1H 2017 to 1.39 and 1.40 in 1Q- and 2Q 2017 respectively.
- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Singapore deteriorated to 4.4 from 4.1. The higher score higher was due to the increase in yield, current account and fiscal risks. This should weigh on the intrinsic value of the SGD. Our model shows that the SGD NEER was last seen 0.97% above the mid-point implied at 1.3621. Upper bound is implied at 1.3351 while lower bound is now at 1.3891.
- **Growth and Inflation Outlook:** The economy expanded by a 1.8% y/y in 1Q 2016, helped by a resurgence in manufacturing. The spark in manufacturing could continue for a while longer given that industrial output growth in Apr-May was up by 1.9% y/y compared to -0.8% in 1Q. This appears in line with the results of the business expectation survey hinting of a moderate recovery following last quarter's dip of 1.0% y/y. We can expect GDP growth to remain supported in 2Q as a result. Externally, exports looks like it is picking up after rising by 11.6% y/y in May, helped by strong non-electronics NODX that offset the dip in electronics shipment. Still, the weak electronics shipment (suggesting continuing weakness in manufacturing) as well as contraction in the non-domestic retained imports in Apr-May period (-9.4% y/y) (hinting that manufacturers are not sanguine about business prospects ahead) do not bode well for the economy beyond 2Q. The government's full-year growth forecast remains at 1-3% for 2016 barring "the full materialization of downside risks", while our economics team continues to expect growth to come in at 1.7% for 2016 before rebounding slightly to 2.0% in 2017.
- Disinflationary pressures intensified in May, sending headline inflation lower by 1.6% y/y from Apr's -0.5% on lower transport cost due to a sharper decline in petrol prices as well as dissipating base effects from the disbursement of service and conservancy charges rebates in May this year. Core inflation (CPI ex-accommodation and private transport) however continued to climb higher, rising by 1.0% y/y in May from 0.8% in Apr lifted once again by higher services inflation (1.5% y/y in May vs. 0.7% in Apr) while food inflation slipped lower (2.2% y/y in May vs. 2.3% in Apr). The MAS outlook for inflation was maintained: imported inflation remains muted given ample supply buffers and weak global demand; oil prices are expected to be higher in 2H

2016 than 1H; and domestic labour market tightness is expected to come off slightly with wages growth projected to slow. The pass-through from wage costs to consumer prices should continue to be constrained by the subdued economic growth environment. MAS continues to expect headline inflation to remain negative and average -1.0-0.0% for 2016. Core inflation is still expected to come in at the lower half of its 0.5-1.5% forecast range, barring a sharp rise in global oil prices. Our economic team expects headline and core inflation to average -0.4% and +0.5% in 2016 respectively.

- **Monetary Policy Forecast:** We do not expect the MAS to adjust its policy again at its Oct meeting after shifting to a neutral policy in Apr. MAS had progressively removed the crawl because the economy did not see the need for an appreciation path for balance and the medium term path is closer to a constant now than upward sloping given current domestic and external conditions. Unlike past occasions when the slope was flattened swiftly, the recent change in the slope was in response to the slow drift to inflation. In the short term, in absence of significant shocks, an adjustment to the NEER band would be unnecessary.
- There have so far been no changes to the MAS' expectations for growth and core inflation as discussed above and the likelihood that the MAS would contribute to financial market volatility by creating any policy-driven volatility. With MTI expecting the Brexit impact on the domestic economy to be modest in the medium- to long-terms, this is unlikely to trigger a MAS response in Oct. Moreover, with MAS standing ready "to curb excessive volatility", a widening of the policy band does not appear to be in the card at the moment as well.
- The risk of another move in Oct is likely to increase should disappointing data threatens the MAS' assumption for growth and core inflation. In the unlikely event that these risks materialize, we could expect the next move by the MAS to be a downward re-centering of the SGD NEER. Thus, while the hurdle for further policy adjustments have been lowered with the policy adjustment in Apr, we expect the MAS to stand pat at its Oct meeting unless risks to its assumptions for growth and core inflation materialize.
- Since our last report, the USDSGD has been choppy but did not result in large swings to domestic interest rates. In fact, domestic interest rates have been relatively stable. To date, the 3-month SIBOR (3MSIBOR) has come off from its five-year high of 1.254% (19-27 Jan) to hover below the 1.0% levels for much of Jun. The more gradual pace of rate increase should also moderate the rise in mortgage rates for now. Deposit rates (for 12-month fixed) have not risen since end-Jan and remains at around 0.35% currently. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, seems limited for now. We continue to expect the 3MSIBOR and 3MSOR to end 2016 and 2017 at 1.33% and 1.44% and 2.30% and 2.41% respectively.
- **Latest Fiscal and External Balance Outlook:** The current account surplus narrowed to SGD17.77bn in 1Q 2016 from SGD20.71bn in 4Q 2015. The narrowing current account surplus could be primarily attributed to the smaller surplus in the goods and services account, which came in at USD26.19bn in 1Q 2016 vs. 4Q's SGD29.20bn in 4Q even as the deficit in the primary balance account narrowed to SGD4.43bn (from -SGD5.26bn in 4Q). The

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

- **Key domestic events and issues to watch:** Advanced estimates for 2Q16 GDP will be released sometime 7-14 Jul.
- **Technical Outlook:** USDSGD reversed the entire upmove from 1.3350 to 1.3840 (seen in month of May) in the month of Jun (just before the referendum outcome). Pair then rebounded and was last at 1.35 levels. Weekly momentum is slight bias to the downside. Support at 1.3350 (interim double bottom formed in Apr and Jun). Resistance at 1.3610 (23.6% fibo of 2016 high to low) before 1.3770 (38.2% fibo).

MYR: Interim Weakness Before Resumption of Strength

Forecast	3Q 2016	4Q 2016	1Q2017	2Q2017
USD/MYR	**4.1000** (3.9500)	**4.0000** (-)	**3.9500** (4.0000)	**3.9500** (-)

Previous forecast in parenthesis.

- **Motivation for the FX View:** We expect sentiment to remain cautious post-Brexit. Taking into consideration the Brexit event and its potential negative repercussion that could linger into 3Q and early-4Q (UK PM steps down by Oct), the shift in our expectation for no Fed hike this year, potential uncertainty leading into US elections (in Nov 2016), we see cautious risk sentiment for 2H 2016 and this could lead to mild support for USD. But we think USD could be more supported against the G7 majors (in particular the EUR and GBP) than against the AXJs. We see potential inflows into AXJs as markets search for higher yielding plays amid a near-zero rate environment (in the developed world). In the medium term, we favor IDR and MYR.
- We are cautious of potential sharp swings in the range of 3.98 - 4.15 as sentiment and liquidity slowly finds its way back over the first half of July. While rising risk of rate cuts (possibly as soon as next meeting) may keep the MYR under pressure, rate cut may also be positive for bond outlook (inflows) and could mitigate some of the negativity surrounding MYR. As long as oil prices remain stable and do not fall sharply in anticipation of expected weaker global demand or supply glut, we should also expect MYR to remain supported and see a resumption of strength in the medium term.
- The drivers underpinning our conviction are both domestic and external driven. We expect the dollar strength to pick up slightly in 3Q given the stress points from UK Brexit negotiations and rising uncertainty from US elections, before some stabilization in markets in 4Q 2016. However see downside risk to the pair is highly likely if oil prices move and EM inflows see sustained inflows.

- External drivers include a 1) rebalancing of global oil supply and demand underway, which saw the decline in oil price volatility to levels not seen since Jul 2015 and rise in oil prices towards $50/bbl handle. (YTD oil prices and MYR correlation coefficient remains significant at 0.75). 2) In search of attractive yields - MYR bond yields remain attractive amid more accommodative monetary conditions globally and still-supported risk sentiment. 3) FOMC rate hike now not a likelihood means a big sell-off in risk assets is low. But risk will materialize around the Jul, Sep, and Dec meetings. We still see the need of a rate hike as a testament to US economy progressing towards recovery (especially when US labor market is near full employment and PCE core inflation has slowly edged above 2%). Taken together, this may not necessarily bode ill for risk assets and may continue to keep sentiment supported.
- Domestic drivers include accommodative monetary conditions at home, re-calibrated budget (perceived as positive), resilient domestic demand as well as improving FX reserves to import and short-term debt. While domestic concerns remain, they are gradually subsiding and this is helping to restore market confidence and improve investor risk appetite.
- In light of the recent market moves from Brexit, we recalibrate our USDMYR forecasts. At the same time we caution for short-term weakness. Topside should still see 4.15/20 levels but if concerns from Brexit dissipate, we could see the USD/MYR test 4.00 and towards 3.95/3.98 levels.
- **Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.55 levels.** We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We still expect to see some stability returning to Ringgit as political/contingent liability risk subsides, fiscal consolidation/reforms gains traction, oil prices stabilize and uncertainty and likelihood of Fed rate hike subsides for the next 6 months.
- External reserves as at 15 June 2016 edged up to USD97.4b (MYR383.2b) from USD97.3b (MYR382.6b) on 31 May 2016, equivalent to 8.1 months retained imports and 1.2 times short-term external debt. Year-to-date, external reserves increased by +2.2% from USD95.3b at end-2015. Latest figure remains up trend amid mix trends in capital flows. The slow and steady rise in external reserves so far this year implies that the current account surplus is sustained (which should allay fears of the narrowing current account surplus in recent years turning into deficit), while in the capital account, net FDI and other capital flows are mitigating the volatile net portfolio capital flows.
- Foreign flows into equities have been very volatile so far this year. Foreign net selling in Jan-Feb 2016 turned into net buying in Mar-Apr 2016 and swing back to net selling since May 2016. Foreigners were net sellers of equities totaling –MYR 2.4b so far in June 2016 and –MYR6.6b since May 2016. The volatile foreign net equity flows reflect factors that effect market sentiment and MYR movements, namely shifting expectations on the timing and quantum of US interest rate hikes, China’s economic outlook, oil price movements, the rebalancing in Malaysia’s weightage in MSCI last month, and current uncertainty over the outcome of UK referendum on its membership of the EU.

- Foreign net flows in the bond market in total are less volatile compared to that of equities amid sustained net foreign buying of MGS which makes up the bulk of the foreign holdings of Malaysian bonds, although the short-term Discount Instruments are more susceptible to swings. Our fixed income research team did an estimate on the foreign holdings of MGS by tenure, where 43% are <3-years; 20% are 3-5 years; 31% are 5-10 years; 4% are 10-15 years; and 2% are >15 years. In addition, foreign holdings of longer-term bonds are on the uptrend, in line with the shift in the supply profile of MGS towards issuance of longer maturity, coupled with good presence of “real money” foreign bond investors with appetite for long duration such as central banks/governments (27% of total foreign holdings of Government bonds as at Feb 2016); pension funds (14%) and insurance funds (2%).
- **Our monthly Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Malaysia remained largely unchanged at 5.3 in May, but saw some deterioration via PE valuation and inflation.
- **Growth and Inflation Outlook: 1Q 2016 real GDP growth slowed for the fourth consecutive quarter** to +4.2% YoY (4Q 2015: +4.5% YoY). **Domestic demand slowed** (1Q 2016: +3.6% YoY; 4Q 2015: +4.0% YoY) due to the virtually stagnant investment (1Q 2016: +0.1% YoY;4Q 2015: +4.0% YoY) from both private and public sectors. **Net external demand declined**(1Q 2016: -12.4% YoY; 4Q 2015: +4.3% YoY) as exports of goods & services declined (1Q 2016: -0.5% YoY; 4Q 2015: +4.0% YoY) while imports of goods & services grew, albeit at slower pace. **The only bright sparks were in private and government consumption.**
- Index of leading economic indicators fell for the sixth consecutive month in Apr 2016 by -2.6% YoY (Mar 2016: -2.1% YoY). The index of leading economic indicators “leads” GDP growth by 2-3 months. On this basis, we calculated it to have contracted further by in 2Q 2016 by -2.0% YoY (1Q 2016: -1.0% YoY), suggesting further downtrend in last quarter’s real GDP growth. Real GDP growth has been slowing for four straight quarters up to 1Q 2016.
- Global economic outlook is now facing a new headwind in the form of “political economy” risk following “Brexit” that suggest political developments are additional unknown and shock variable, especially if “Brexit” signals trends towards anti-globalisation and inward-looking politics, policies and economies that will be a blow to the already fragile and lackluster global economy and world trade. Our full-year real GDP growth forecast of +4.3% for this year is under review **(vs. Official 2016 growth forecast stay at 4.0%-4.5%).**
- The +4.3% forecast was based on **a bottoming in the quarterly growth slowdown suggested by the back-to-back pick up in consumer spending, implying GST effect may be over. Public investment is also expected to recover** from the 1Q 2016 drop, taking cue from the recent awards of contracts under major public sector infrastructure and investment projects like KVMRT2, PBH and RAPID. There is also the **potential upside to Government spending in view of the rebound in crude oil price** to around USD47/bbl currently (2016 YTD: USD37/bbl) vs Budget 2016’s assumption of USD30-35/bbl average for the year.

- However, the **prospect for private investment is challenging amid general economic uncertainty and pressures on corporate profitability** that make companies cut, withhold or slow their capex. The “wild card” is net external demand, which as volatile as the global environment, commodity prices and currency. And with Brexit, it has turned it slightly weaker.

- **Our Economists lowered 2016 inflation forecast range by -0.3 ppt to 2.7%-3.2% (2015: 2.1%) from 3.0%-3.5% previously.** Besides the GST base effect, the cha**nge reflect subdued global inflation** given the persistent deflationary environment. Domestically, the slow**ing GDP growth results in our Economists' estimate of negative output gap last quarter, which would cap demand-pull inflation.**

- Inflation looks set to be stable going forward in 2016 as we maintain our 2016 headline inflation rate forecast range at 2.7%-3.2% (official: +2.5%-+3.5%). The first quarter of the year marked the highest quarterly CPI inflation post GST period at +3.4% YoY, after it peaked at +4.2% YoY in Feb 2016. With CPI inflation in May 2016 being the lowest so far for the year, we expect CPI inflation to be much lower at +2.2% in 2Q 2016 on the GST base effect and subdued global inflation. This is further supported by the slowing economic growth expected at +4.3% YoY in 2016 (2015: +5.0%) that produced negative output gap last quarter which helps to cap demand-pull inflation.

- Nevertheless, we expect volatile trend in monthly inflation rate, due to factors such as the volatile currency and commodity prices –especially crude oil prices; weather and seasonal effects on food prices; scheduled reviews and the still-pending decisions on “administered prices” like the gas and electricity prices as well as PLUS highway toll rates; the cost impact of specific domestic policies, such as the hike in levy on foreign workers effective 18 Mar 2016 (Peninsula Malaysia for now) and the Minimum Wage increase on 1 July 2016.

- We continue to be mindful of the Price Control & Anti-Profiteering Act's restriction on traders' price increases between 2 Jan 2015 and 30 June 2016 toprevent “profiteering” and excessive price increases following GST implementation. There is the risk of price hikes after the expiry of this restriction period in view of the higher operating costs due to the various non-GST factors like the continued subsidy rationalisation/removals, reviews administered prices, and the above-mentioned labour costs.

- As expected, headline and core inflation rate stayed low at+2.0% YoY (Apr 2016: +2.1% YoY) and +2.1% YoY (Apr 2016: +2.3% YoY) respectively. YTD 2016 headline inflation is +2.9% YoY while core inflation is at +3.0% YoY. The **moderation in both CPI and core CPI reflect base-effect from GST introduction back in Apr 2015 amid the broad-based easing in all CPI components in Apr 2016.**

- **Monetary Policy Forecast:** The Monetary Policy Committee (MPC) meeting on 18-19 May 2016 was the first chaired by the **new Governor Datuk Muhammad Ibrahim,** who replaced Tan Sri Dr Zeti Akhtar Aziz effective May 2016 for a five-year term. The MPC decided to release **future Monetary Policy Statement (MPS) on the second day of the MPC meeting earlier at 3pm instead of 6pm.**

- **BNM kept the Overnight Policy Rate (OPR) and the Statutory Reserve Requirement (SRR) ratio unchanged at 3.25% and**

3.50% respectively on 19 May. BNM described the current levels of OPR at 3.25% as accommodative and supportive of economic activity,

- Our Economists are **not ruling out the possibility of a 25bps cut to OPR (now at 3.25%) in 3Q 2016**, depending on whether economic data between now and up to the release of 2Q 2016 real GDP in mid-Aug 2016 show quarterly growth has bottomed or not. Given the latest Brexit developments, we are raising the probability of a potential Jul hike.

- There was also no change in SRR, currently at 3.50%, indicating that **BNM is comfortable with current domestic liquidity**. Money supply (M3) growth picked up but remained sluggish (Apr 2016: +1.5% YoY; Mar 2016: +0.9% YoY) amid the fall in total deposits and slower credit growth. On monthly basis, M3 shrank -0.1% MoM in Apr 2016 (Mar 2016: +0.1% MoM). The trend in money supply is consistent with downward pressure on GDP. Interbank rates continued to head lower in Apr 2016. The 3-month interbank rate dropped to 3.69% p.a. at end-Apr from 3.71% p.a. at end-Mar 2016 and 3.79% p.a. at end-Jan 2016 versus the high of 3.84% in Dec 2015.

- **Latest Fiscal and External Balance Outlook:** According to the latest revised budget (released 28 Jan), the government aims to maintain its 2016 fiscal deficit at 3.1% of GDP via a series of restructuring steps (operating and development expenditures cuts) that are expected to save the government MYR9bn. Malaysia's fiscal and broader economic outlook could still be under pressure from weaker commodity prices in 2016. **The revised Budget has adjusted lower its oil price assumption to US$30-35/bbl (from $48/bbl).** Downside pressure on rating agencies' 'Stable' outlook could arise in 2H 2016 if oil price averages below US$30/bbl as that may trigger projection of fiscal revenue shortfall.

- Exports picked up slightly in Apr 2016 by +1.6% YoY (Mar 2016: +0.2% YoY) in contrast to second monthly fall in imports (Apr 2016: -2.3% YoY; Mar 2016: -5.5% YoY), resulting in +MYR9.1b trade surplus (Mar 2016: +MYR11.2b). Global trade stays weak so far this year, but firmer oil prices and continued soft USDMYR average offer some upsides for Malaysia's exports, although imports point to lukewarm domestic demand at the start of 2Q 2016. The outlook for exports is challenging amid the lackluster global trade, which shrunk in both value and volume so far this year. Our economics team sees low single-digit export growth forecast of +3.4% for this year (2016YTD: +1.6%; 2015: +1.9%) and is reflective of the tepid world trade, but also factored in the upsides from the crude oil price rebound and the competitive advantage of a weaker average MYR vs USD of 4.07 (2015: 3.91).

- Volatility in commodity prices continues to weigh on commodity exports albeit with less of a drag, while manufacturing exports appear to be improving. We are also keeping an eye on the impact of recent change in domestic labour policy amid complaints by businesses -including manufacturing exporters -on the adverse cost and operating effects of the hike in foreign workers' levies, freeze on intake of new foreign workers, as well as the upcoming Minimum Wage hike on 1 July.

- **Key domestic events and issues to watch:** Key domestic events and issues to watch: MPC Meeting (13 Jul); Trade data (1 Jul); FX reserves (5 and 22 Jul); CPI Inflation (20 Jul).

- **Technical Outlook:** USDMYR's run-up since late Apr hit resistance around 200 DMA and since then, has drifted lower (barring some upside squeezes in the run-up to FoMC meeting in mid Jun and in reaction to *Brexit* outcome). Last seen around 4.03 levels. Monthly, weekly and daily momentum indicators are exhibiting early signs of bearish bias. Next support at 3.9850 (23.6% fibo retracement of 2016 high to low). A break below that on weekly basis can see the pair push lower towards 3.85 levels (2016 lows). Resistance at 4.0720 (38.2% fibo), 4.1420 (50% fibo) before 4.1670 (200 DMA).

IDR: Positive Domestic Factors

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDIDR	13400 (13300)	13300 (13150)	13200 (12950)	13200 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USDIDR has had a choppy ride so far in Jun. Pair had been pulled in different directions by expectations that the Fed would hold off further rate hikes on one side to expectations of further easing by BI on the other. The jolt in the month came from an unexpected source – the UK's decision to leave the EU. That black swan event sent the USDIDR spiking past the 13500-levels but only temporarily before easing lower. The IDR has risen about 0.6% against the USD since the Brexit vote. This makes the IDR one of only two currencies we cover that have moved in the opposite direction to the rest of the Asian currencies.
- Against market expectations, BI cut its reference rate for the fourth time this year by 25bp to 6.50% at its Jun meeting, taking advantage of the pause in US rate hikes to adjust its own rates to spur credit growth and support growth. Our economic team expects another 25bp rate cut in Aug-Sep but a move could come as early as the 21 Jul meeting if the pass-through of the rate cut to the economy is to be felt by the last quarter of the year and into 2017. This should weigh on the IDR and keep the USDIDR elevated in 3Q 2016.
- The gain in the IDR against the USD in recent days post-Brexit can be attributable to the tax amnesty law (*see table 1*), which is expected to officially begin on 11 Jul. The lower penalty provisions in the tax amnesty law are valid for only nine months until end-Mar 2017. The tax amnesty bill had been greatly anticipated by the market and is viewed positively as it would not only onshore funds that have been parked overseas that could be used for capital investment's domestically, but that could also resolve some of the shortfall in government revenue, decreasing fiscal risk. These repatriated funds could provide the government with the revenue it requires to fund its infrastructure programmes if the implementation of the tax amnesty plan proceed without a hitch. This in turn is expected to encourage greater portfolio inflows and FDIs into the economy. These flows should be positive for the IDR in the medium term.

- However, whether the USDIDR will settle lower to around the 13000-handle would depend on how much of the estimated IDR560tn that the BI believes will be repatriated are actually shifted back onshore. Should the actual funds repatriated fall significantly below that estimate, the gains in the IDR could be limited. However, should the estimate be met or exceeded, there could be downside risks to the USDIDR outlook with the possibility of the pair settling closer to the 13000-handle in 1H 2017.

Table 1: Penalties Imposed By Tax Amnesty Law

Assets Overseas	Compliance Period		
	3Q 2016	**4Q 2016**	**1Q 2017**
For Individuals:			
Declared BUT Not Repatriated	4%	6%	10%
Declared AND Repatriated	2%	3%	5%
For SME with Gross Income of up to IDR4.8tn in the latest tax year:			
Assets up to IDR10bn	0.5%		
Assets of more than IDR10bn	2.0%		

Source: Various News Reports, Maybank FX Research

Note: Minimum lock-in period is 3 years and repatriated funds can be invested in infrastructure bonds, government bonds, mutual funds with specific objectives, real sector investments designated by the MoF.

- Up to 27 Jun, foreign investors have purchased a net +USD348tn in equities, while at the same time, adding a net +IDR21.23tn to their outstanding holding of government debt on 1-24 Jun (latest data available). This is an improvement over the net -USD17.27tn of equities sold off in May and the net -IDR4.21tn that was removed from their holding of government debt in the month. Year-to-date, foreign funds have purchased a net +USD668.3mn in equities compared to the net -USD1.58bn for the whole of 2015. They have also added a net IDR84.67tn to their outstanding holding of government debt so far this year, almost on par with the IDR97.17tn accumulated for the whole of 2015. The foreign inflows to date, and which is likely to continue as long as the infrastructure programme and reform policies remain on track, should be IDR-positive and allow the USDIDR to edge lower for the rest of the year.

- Aside from the tax amnesty bill, other positive factors that favor the IDR are the improvement in economic fundamentals (including narrower current account deficits), government liberalization initiatives and reforms to the domestic economy. These have been key to risk-supported sentiments and supportive of the IDR so far. The 13 stimulus packages introduced to date by the government have not only encouraged greater foreign portfolio investment but FDI. We have already had a good start to FDI so far with FDI rising by 17.6% y/y in rupiah terms in 1Q. In addition, the government has signaled its intention to move ahead with reforms and liberalization of the economy with the launched of a task force headed by Coordinating Minister for the Economy Darmin Nasution himself to ensure the timely and effective implementation of the 13 stimulus packages.

- At the same time, greater political stability is expected with the inclusion of the Golkar Party - the second largest party in parliament - into the ruling coalition. This provides President Jokowi with a majority in parliament for the first time since he came into office. The quick passage of the tax amnesty bill can be taken as a testament of this new parliamentary strength, though other legislative challenges could lie ahead for the president. Still, the strengthening of the ruling coalition in parliament should provide the president with the impetus to push ahead with reforming the economy and pushing through necessary legislations. All of these reaffirm our positive take on the IDR.

- Despite the risk aversion wrought by Brexit that is keeping USIDR elevated, these positive idiosyncratic factors should mitigate and allow the USDIDR to drift lower from here on. We look for the pair to remain above the 13000-levels for the rest of the year with USDIDR ending 3Q and 4Q at 13400 and 13300 respectively. Though we expect a US rate hike in 1H 2017, these positive domestic factors should still allow the pair to settle lower at around 13200 in 1H 2017.
- **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Indonesia worsened to 5.6 from 5.4 and was due to the deterioration in fiscal risks. This should weigh on the intrinsic value of the IDR.
- **Growth and Inflation Outlook:** With growth disappointing in 1Q 2016, expanding just 4.92% y/y, attention is now focused on the economy. This moderation in growth was likely the key reason that BI moved to cut its policy rate in Jun. The outlook for private consumption has so far been mixed as reflected in motorcycle and car sales in May. Motorcycle sales slipped lower again in May by 1.7% y/y though this was more moderate than Apr's -8.9%. Car sales however picked up, rising by 11.5% y/y in May (Apr: +3.8%). Domestic problems aside, exports remain in the doldrums, contracting for the 20th straight month by 9.75% in May, while imports fell 4.12%. Still despite the slow start to the year, our economic team remains sanguine about growth prospects in 2016. They expect the government's push for more infrastructure building and stronger investment, incentivized by government's offer of tax breaks, to drive growth. This should allow the economy to expand by 5.09% in 2016, a moderation from their previous forecast of 5.20% and which remains in line with the recent BI's 2016 GDP growth forecast of 5.0-5.4%.
- Headline inflation has been broadly on the downtrend since the start of the year. From the mid-4% levels at the beginning of the year, headline inflation is now closer to the 3.0% levels in May. Headline inflation was at 3.33% y/y in May from 3.60% in Apr. However, inflation is likely to tick higher in Jun in the lead up to the end of Ramadan celebrations with prices driven higher by demand for goods and services. Core inflation is also expected to edge higher after holding steady at 3.41%, lifted by rising gold jewelry prices, car prices, housing rent/contracts and transportation tariff. Given more benign inflationary pressures to date, our economic team is expecting headline and core inflation to average 3.53% and 3.48% in 2016 respectively instead of 3.98% and 3.53% previously. This forecast change remains within BI's inflation forecast of 3-5% for 2016.
- **Monetary Policy Forecast:** Against market and our expectations, BI cut its reference rate (as well as the 7-day reverse repo) for the fourth time this year by 25bp to 6.50% (and 5.25%) at its Jun meeting. The BI took advantage of the pause in US rate hikes,

amid benign domestic inflation, to adjust its own rates to spur credit growth and support growth. According to Juda Agung, executive director of monetary policy at BI, growth was the main focus of the policy meeting and the economy was seen as being under pressure because of weaknesses in private investment from non-construction industries. BI also complemented the rate moves with an easing in macro-prudential limits to help spur lending, which we had advocated in our previous report. The central bank lifted minimum loan-to-funding ratio to 80% from 78%, loosened rules on property purchases and reduced the minimum deposit required to buy homes.

- With policy already accommodative, further easing by the central bank might not be on the cards as warned by Agung. However, we cannot rule out further easing by BI if the risks from Brexit continue to reverberate through the global economy and financial markets, impacting on the domestic economy. Our economic team expects another 25bp rate cut in Aug-Sep but a move could come as early as the 21 Jul meeting should the BI want to provide more insurance for the economy against Brexit risks amid a relatively stable IDR and benign inflationary environment. We now do not expect the transition to the new benchmark rate – the 7-day reverse repurchase rate (currently at 5.5%) – and the re-adjustment of the interest rate corridor on 19 Aug to constrain any future BI action.
- **Latest Fiscal and External Balance Outlook:** With the tax amnesty law now a reality, the central bank estimated that IDR560tn in undocumented funds overseas could return to the country and earn the government IDR53tn in revenue. This should help the government with its revenue shortfall, lowering fiscal risks, and provide the government with more fiscal space for the government to embark on its infrastructure spending programmes. Because of this shortfall in government revenue, the government had to revise its 2016 budget, particularly for a higher fiscal deficit. The new budget assumptions recently approved by Parliament include 2.35% of GDP fiscal deficit, oil price at USD40/bbl, average USDIDR at 13500, and 2016 GDP growth and inflation at 5.2% and 4.0% respectively.
- The current account deficit (CAD) narrowed moderately to USD4.67bn in 1Q 2016 or 2.14% of GDP compared to USD5.07bn in 4Q 2015. This was better than the 2.20% BI was expecting and was just a tad off last year's full-year CAD of 2.06% of GDP for 2015. The moderation in 1Q 2016 CAD was due to the larger deficit in the primary income account (-USD7.55bn) that offset the larger surplus in goods and services account (USD2.78bn).The overall balance of payments slipped into a deficit of USD0.29bn in 1Q 2016 as the surplus in the financial account was more than offset by the CAD. The central bank continues to expect the CAD to come in at 2.5% of GDP in 2016, less than the 3.0% of GDP target. Meanwhile, our economic team maintains its 2016 CAD forecast at 2.45% of GDP.
- **Key domestic events and issues to watch**: BI meets on 21 Jul to decide on monetary policy.
- **Technical Outlook:** USDIDR turned lower in Jun, from a high of 13705 (2 Jun) to 13131 (29 Jun). Pair was last seen at 13180 levels. Underlying momentum remains bearish (as indicated on monthly and weekly charts). 21 DMA has cut 50 DMA to the downside and looks on course to cut 100 DMA to the downside. Could see the pair remaining heavy. Resistance at 13224 (23.6%

fibo retracement of 2016 high to low), before 13372 (38.2% fibo). Support at 12984 (2016 low).

PHP: Awaiting Clearer Policy Direction

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

No Change from Previous Forecast

- **Motivation for the FX View**: The USDPHP has mostly been on the climb higher since the second week of Jun as the feel-good-factor after the peaceful election on 9 May became a distant memory. Markets instead focused on the US Fed rate hike trajectory and then on the UK referendum on its EU membership that trigger a deterioration in risk appetite. The run-up to the UK referendum and then finally the Brexit outcome weighed on the PHP, sending the USDPHP higher above the 47-figure. Nevertheless, the pair managed to weather the market turmoil quite well, losing about 1.1% against the USD in the days after the Brexit outcome compared to its regional peers like the SGD and MYR.
- The resilience in the USDPHP can be explained by the still healthy inflows into equities the days leading up and immediately after the UK referendum. In the days after the UK referendum (24-27 Jun), foreign investors purchased USD11.15mn in equities, almost equal to the total purchased of USD11.9mn from the beginning of the month to 23 Jun. Similarly, yields across most government bond tenors were lower on 24-27 Jun by 0.5-14.3bp except for the 2Y, 4Y, 10Y and 20Y, suggesting demand for governemt debt was relatively healthy. This probably helped to offset the long USDPHP positions taken by investors in the wake of global risk aversion.
- Moreover, the strong economic fundamentals to date, including persistent current account surpluses, economic growth outperformance and still accommodative monetary policy, should provide the backstop to any rapid bounce in the USDPHP. In addition, expectations that there will be no Fed rate hike in 2016 should also provide relief for the USDPHP, as higher yields in the Philippines could continue to attract foreign portfolio inflows.
- So far, President Duterte's appointment of a balanced cabinet consisting of politicians to the left of the political spectrum, those with Davao-links and technocrats have not disappointed foreign investors. Particularly, the appointment of Carlos Dominguez III as Finance Secretary-designate has won investor praise, helping to imbue more confidence among foreign investors in the ability of the new administration to move the economy forward. Moreover, the 10-point socio-economic agenda proposed by Duterte's economic team has helped to affirm policy continuity. Still, it must be noted that these gentlemen are over the age of 70 and their lack of youth could work against them down the road.
- Despite the initial feel good factor following the peaceful election, we believe this could dissipate as the reality of governing an entire country vs. that of a city hits. President

Duterte might not find pushing his platform through the Congress as easily as when he was mayor of Davao City. Moreover, his anti-establishment and anti-Manila outlook could also work against him. We may thus still see political risks increase in the days ahead. These are some of the risks that we will be monitoring closely, and that could keep the USDPHP supported ahead.

- Aside from domestic risks factors, external events could also impact the USDPHP, particularly the US presidential election. The uncertainty in the lead-up to the US presidential election could pose upside risk to the USDPHP. Concerns about a "President Trump" could increase market volatility and a search for safe-havens, sparking another round of outflows from riskier assets including those from the Philippine and lifting the pair higher.
- Nevertheless, we expect the pair upmoves to be capped below the 48-figure this year. We maintain our forecast for the USDPHP to end 2Q at 47.000 before climbing higher towards 47.50 by end-3Q and then to 47.80 by end-2016. Thereafter, we expect the pair to settle lower to 47.50 by 1Q 2017 after the uncertainty surrounding these risks events dissipates.
- Our monthly **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, 4.3.0. This could be attributed to increase in inflation and fiscal risks. This should weigh on the intrinsic value of the PHP.
- **Growth and Inflation Outlook**: GDP growth has so far outperformed its 5-year average of 5.9% when it expanded by 6.9% y/y in 1Q16. The 10-point socio-economic agenda issued by President Duterte's incoming economic team provides a blue-print of the economic direction under a new administration. Key in the agenda was the continuation and maintenance of the current macroeconomic policies, including fiscal, monetary, and trade policies of the previous Aquino administration. This has provided confidence among foreign and domestic investors that nothing would change significantly on the economic front. However, there is a caveat to this as we had discussed previously - these points in the agenda are not carved in stone and is subject to further discussion. Thus, there could still be changes made to the direction of economic decision-making under President Duterte.
- Until the policy direction of the economy is known, we continue to expect the economy to accelerate in 2016 underpinned by election-related spending and front-loading of government projects. Moreover, the incoming government intends run a larger fiscal deficit of as much as 3% of GDP to spending on building infrastructure. All of these should boost both domestic consumption as well as investment spending, and mitigate any slowdown in remittances as a result of slower growth in the G3 and oil-producing Middle Eastern economies. Barring policy surprises from the new administration, our economic team continues to expect growth to come in at 7% for 2016.
- Headline inflation rebounded slightly to 1.6% y/y in May after stalling at 1.1% in Mar and Apr, helped by the uptick in food prices (2.3% y/y) and smaller decline in housing cost (-1.2% y/y). Headline inflation has averaged 1.2% y/y in the first five months, way below the official 2-4% target for 2016. Much of this underperformance in inflation is due to oil prices. Still, inflation could tick higher as oil prices stabilize but should remain muted. Even the risks of El Nino and election spending is unlikely to lift

inflation significantly higher. The central bank believes that inflation is likely to come in around 2.1% in 2016 and at 3.1% in 2017. Similarly, our economic team only expects inflation to average 2% in 2016 based on sustained low fuel prices and modest impact from El Nino.

- **Monetary Policy Forecast:** We continue to expect the BSP to stay on hold at its next policy meeting on 11 Aug – there is no central bank policy meeting in Jul – and probably for the rest of the year. The new interest rate corridor (IRC) is in operation as of 3 Jun with **the overnight borrowing rate at 3.0% (the policy rate) and the upper (overnight lending rate) and lower (overnight deposit rate) bands of the corridor at 3.5% and 2.5% respectively.** Note that the current policy rate at 2.0% is lower than the policy rate before the transition to the IRC at 4.0% - a de-facto 100bp rate cut. With a lower policy rate in place, the central bank is likely to stand pat and keep their ammunition dry as they wait for clarity in President Duterte's economic policy direction amid Brexit risks. Moreover, inflation remains soft and unlikely to weigh on the economy and growth continue to perform, thus making any rate adjustment unnecessary.
- **Latest Fiscal and External Balance Outlook:** There was further good news as the term of President Aquino comes to an end. The fiscal balance which has been in deficit in Dec 2015-Mar 2016 finally turned the corner to record a surplus of PHP55bn in Apr (Mar: -PHP74.4bn). This was the result of a jump in revenues of 17.9% y/y to PHP246.6bn that offset the moderation in spending, which came in at PHP191.6bn. However, this positive print could be short-lived as the fiscal balance could return to a deficit in 2Q given elections spending and the push towards more infrastructure projects and as revenue collection lag.
- The overall balance of payments (BoP) recorded a bigger surplus of USD241mn in May vs. USD184mn in Apr. This was probably due to a return of portfolio flows in May after outflows in the previous month as well inflows from the central bank's operations. The overall BoP deficit in the first four months of USD26bn has rebounded to a surplus of USD215bn in the year to May. The central bank governor expects the BSP's projection of an overall BoP surplus of USD2bn in 2016 to be met, driven by further inflows ahead, robust domestic demand, stable inflation and sound banking system. The BSP also expects the current account surplus to hit USD5.8bn in 2016.
- **Key domestic events and issues to watch:** There are no events of significance in Jul.
- **Technical Outlook:** An interim appears to have been formed on USDPHP at 45.90 levels (Apr and Jun lows). Pair was last seen at 47 levels. Weekly momentum and stochastics indicators are indicating mild bullish bias. Next resistance at 47.55 (76.4% fibo retracement of 2016 high to low), before 48.07 (2016 high).

THB: Political Tensions Could Re-emerge

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/THB	36.50	37.00	37.00	37.00

No Change from Previous Forecast

- **Motivation for the FX View:** USDTHB has been relatively resilient to Brexit risks. It was the second most resilient currency in ASEAN after the IDR. The baht fell by just 0.3% against the USD in the aftermath of the Brexit vote. This was even though foreign funds sold-off Thai assets for safer havens. This resilience could be attributed to foreign investors having already begun to reduce their exposure to Thailand earlier. Aside from softer global risk appetite and firmer dollar, political tensions in the lead up to the 7 Aug referendum on the new constitution could also keep the pair supported.
- In the days that followed the Brexit outcome, foreign investors fled Thai assets as expected. On 24 and 27 Jun, THB2.11bn and THB3.66bn of equities and government debt were sold-off. This was only a fraction of THB10.71bn and THB71.05bn that had flown in for 1-23 Jun. In contrast, foreign investors sold off THB0.86bn in equities in Apr-May after accumulating THB26.45bn in equities in Mar. Similarly, they bought only THB19.81bn in government debt in Apr-May compared to the THB95.85bn purchased in Mar. Thus, the paring of equity and government debt holdings by foreign investors in the prior months have put the USDTHB in good stead to withstand the turmoil unleashed by the Brexit vote.
- Nevertheless, the pressure remains for the USDTHB to climb higher towards the end of the year. The referendum set for 7 Aug to seek the public endorsement for the new constitution will be the key event to watch. With the Constitutional Court ruling for the military government's law that criminalizes campaigning for or against the draft constitution, political tensions could come to a head in the run-up to the referendum. The military government's attempt to solidify the military's role in the constitution and limit the role of civilians could galvanize the opposition. There are risks that tensions intensify and if it blows up, impact investor sentiment and increase downside pressure on the THB.
- Aside from domestic political risks, political risks from abroad are also likely to impact the USDTHB, particularly the US presidential election. The uncertainty in the lead-up to the US presidential election could pose upside risk to the USDTHB. Concerns about a "President Trump" could increase market volatility and a search for safe-havens, sparking another round of outflows from riskier assets including those from the Thailand and lifting the pair higher.
- Though the IMF has called for the BoT to cut its policy rate, we remain convinced that the BoT will stand pat on policy in 2016, barring unforeseen risks to the economy. Rate cuts would not

solve the kingdom's export woes as a weak THB to mitigate weaknesses in global demand. Moreover, the policy rate is already at near historical lows and is unlikely to be effective in spurring further lending or investment activities. In addition, the central bank views accommodative monetary policy as complementary to fiscal policy, which should take the lead in supporting the economy. Just as importantly, the central bank is likely to save its limited ammunition for even more averse shocks to the economy that could come either domestically or externally. A possible risk to our policy rate outlook is a rate hike in 4Q 2016 as the economy rebounds by year-end, but this not our base case for now.

- USDTHB risks remain to the upside as such given recent market developments. The USDTHB climb higher remains intact and should end 3Q at 36.50 and then settle higher at end-4Q at 37.00 and into 1H 2017.
- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Thailand held steady at 4.0 from last month with the decrease in yield risk offset completely by the increase in PE valuation risks. This should continue to be supportive of the intrinsic value of the THB.
- **Growth and Inflation Outlook:** Things appear to be looking up for the economy. Recent data releases appear to reaffirm that the economy is on a recovery path but more data points are required to confirm a trend. Private investment and consumption index both have risen by 1.45% and 5.3% y/y respectively in May. This suggests that domestic demand (including accelerated government spending) is likely to underpin the recovery ahead. External demand though remains weak with exports declining by 3.7% y/y in May, moderating from Apr's larger decline of 7.6%. Similarly, import growth is flat (May: -0.2% y/y) after contracting by 13.4% in Apr. This data seems to suggest that growth is gaining traction. This optimism is shared by PM Prayuth, who expects growth to come in at 3-3.5% in 2016 before accelerating to 3.7-4.2% in 2017. Our economic team is even more optimistic, expecting growth to expand by 4.0%, bolstered by government accelerated government spending and infrastructure projects.
- After declining for the past 15 months primarily due to the plunge in global oil prices and its effects, inflationary pressures have re-emerged. Headline inflation has risen by 0.46% y/y in May after climbing back to positive territory in Apr (+0.07%). Lifting headline inflation higher was food prices, which rose 2.97% in May from 1.57% as a result of the drought. Moreover, tobacco prices were higher as a result of the excise tax hike. However, lower energy prices and transport cost provided some mitigation to higher overall prices. Our economic team continues to expect further upside to inflation this year. Our team expects low base effects, improving domestic demand, the impact of the drought on raw food prices, the firmer oil prices and the weak THB to lift consumer prices ahead. Our economic team now expects headline inflation to come in at 2.0% in 2016 instead of 2.5% previously. This is still higher than the 0.6% expected by the BoT (which was downgraded from 0.8%).
- **Monetary Policy Forecast:** The BoT has left its policy rate unchanged at 1.50% since 29 Apr 2015. The last time the policy rate was lower was during the Great Financial Crisis in 2009-10. With the rate already at near historical lows, there is little need for the BoT to adjust the policy rate for now. This is even though

the IMF has called for the central bank to cut rate to support the economy. We do not share the IMF views and expect the central bank to remain on hold for the rest of the year. Still, this does not preclude the central bank from adjusting its policy rate if the situation calls for it.

- The BoT believes that government spending should do the heavy lifting in supporting growth and for monetary policy to play a complementary and supporting role. We do not expect any rate adjustments in 2016 as the concomitant weakness in the THB from a rate cut is unlikely to be a panacea for the kingdom's export woes. Moreover, the increasing likelihood that the Fed will remain on hold in 2016 and probably hike its Fed fund rate again sometime in 1H 2017 should provide more room for the BoT to maneuver and allow it to keep its ammunition dry for black swan events. A risk to our policy view is the possibility of a rate hike by the BoT should the economy grow at a more rapid pace than expected by both the government and market and this could result in a 25bp hike by the end of the year if growth comes in as expected by our economic team.
- **Latest Fiscal and External Balance Outlook:** Revenue collected in the first eight months of the fiscal year rose 13.4% y/y to THB1.56tn, largely due to one-off items like the revenue from the sale of 4G mobile licenses and income from state enterprises. The mobile license auctions netted for the government THB48.2bn. This brought revenue collected 4.1% above the target in the first eight months of the year.
- The current account surplus narrowed again in Apr, rising to THB111.02bn from THB174.5bn in Mar. The narrower surplus was due to a steeper moderation in the trade surplus of THB85.96bn in Apr from THB165.2bn in Mar, which offset the increase in the income surplus of THB25.05bn in Apr (Mar: THB8.33bn). The overall balance of payments (BoP) surplus in Apr was half that of Mar, coming in THB57.06bn as compared to Mar's THB111.30bn.
- **Key domestic events and issues to watch:** There are no events of note in Jul.
- **Technical Outlook:** USDTHB drifted lower over the past month. Last seen at 35.20 levels. Weekly momentum is showing tentative signs of mild bearish bias. Next support at 35 levels (38.2% fibo of 2015 low to high) before 34.50 (50% fibo). Resistance at35.65 (23.6% fibo).

INR: Shaken By Rajan's Departure

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/INR	**68.50** (67.50)	**69.50** (68.00)	**70.00** (68.00)	**70.00** (68.50)

Previous Forecasts in Parenthesis.

- **Motivation for the FX View:** The rupee seems poised for underperformance against its regional peers ever since RBI Governor Rajan announced his exit from the central bank. The recent ousting (yes we use the words ousting as the whole process seems like it) of RBI Governor Rajan has undermined the confidence that foreign investors have in India. It started with a series of verbal attack by parliamentarian Subramanian Swarmy who questioned his allegiance to India. The frustrating calm of PM Modi underscored his silent support on the attack and led to the eventual departure of Governor Rajan. Finance Minister Jaitley was the only one who spoke up for him and now his Chief Economic Adviser, Arvind Subramanian, a potential successor to Rajan, is the next target of Swarmy. Notwithstanding the possibility of infighting within the BJP, the latest series of attack on technocrats for political motives could undermine investors' confidence.

- With the mud-slinging threatening the Chief Economic Advisor and possibly the Finance Minister, the BJP has came out to show support for the Arvind Subramanian. So far, the list of potential successors to Rajan (including Arvind Subramanian, Shaktikanta Das, Urjit Patel, Rakesh Mohan, Arvind Panagariya. Subir Gokarn, Arundhati Bhattacharya) are slanted towards the dovish camp and chances of a rate cut seems to have increased but recent citings of top sources with the Finance Ministry has indicated the preference for central bankers which puts Urjit Patel (Deputy Governor), Rakesh Mohan and Subir Gokarn at the top of the list. In addition, the new Governor needs to press on with the urgent clean up of bank's balance sheet by Mar 2017. These uncertainties are likely to keep the rupee under pressure well beyond the appoinitment of the new Governor by Modi and Jaitley. The sell-off has begun on 20 Jun. Foreign investors sold U$78.3mn of equities and U$342.7mn of bonds on Mon and there could be more outflows ahead. In addition, a post-Brexit world is likely to weigh on the rupee. **Weakening risk appetite could spur more outflows out of the high-yielding domestic bond market. We look for spot prices to revisit the year high of 68.7887. We are not naïve to think that RBI would stay out of the market. The central bank has amassed record amount of forex reserves, last registered at U$363.2bn and this could be the time to utilize it. Hence, the upmove of USDINR would be tempered.**
- **Our Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for India improved to 4.7 (with 1 being the best score and 9 being the worst) from previous 5.3 due to a significant improvement in its fiscal score relative to its peers.
- **Growth and Inflation Outlook:** Industrial production deteriorated to -0.8%y/y from previous 0.3%. PMI-mfg inched higher to 50.7 from 50.5. The RBI industrial outlook survey for 2015-2016 shows drop in production, order books, overall business situation compared to the response received this time last year. A slowdown in the Indian manufacturing activities. Capacity utilization seems to have improved the most amongst the medium sized enterprises, flat for large firms, and deteriorated for small and micro firms.
- While industrial output growth struggles, the agricultural sector may a key support sector for GDP growth in the months ahead. A good monsoon could boost farm growth to 6% this year and add 40bps according to our India analyst. This is also underscored by government's efforts to support the rural sector. Rural productivity, farm income and rural demand could see a rise amid benign inflation trajectory. Household consumption will continue

to be a pillar of support as the government and central bank strive to crowd in private investment with reform measures.

- Food inflation continued to drive headline higher although core inflation steadied. CPI inched higher to 5.76%y/y from previous 5.47%, exceeding the expected 5.6%. Wholesale prices also rose to 0.79%y/y from previous 0.34%. Expect food cost to remain elevated on base effects but improving harvests (depending on the monsoon) could anchor inflationary expectations into Sep-Oct and bring the headline lower.

- **Monetary Policy Forecast:** The Reserve Bank of India will make its next rate decision on 9th Aug. The central bank did not act in Jun, as expected, citing concerns on the upside surprise in CPI for Apr and we continued to anticipate an extended pause by the central bank ahead of Monsoon period which starts in Jun. Apart from the monsoon outturn, inflation rate and growth trajectory which has been wanting, Modi and Jaitley's choice of RBI Governor would also be key to the policy stance. Local press had stated sources close to the MOF that central bankers are preferred and that puts Urjit Patel (Deputy Governor), Rakesh Mohan and Subir Gokarn (former Deputy Governors) at the top of the list. Urjit Patel is seen as a hawk while Subir Gokarn and Rakesh Mohan are seen as neutral or holding a balanced view for growth vs inflation targeting when it comes to monetary policy.

- **Latest Fiscal and External Balance Outlook:** Foreign investors bought USD657.4mn of equities and sold USD880.5mn of bonds in Jun as of 23 Jun. Expectations are for RBI to hold repo rates as we enter into monsoon season. On the other hand, the recent allowance for foreign investors to own 100% of civil and defense aviation in India buoyed stocks at home. In addition, the government is considering to ease foreign investment in pharmaceuticals.

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

- Current account deficit narrowed to just $0.3bn in the quarter ending Mar from the previous $7.7b due to the better performance of net exports of goods (-U$34.0bn vs previous U$37.4bn) and greater net current account services surplus at USD18bn.

- **Key domestic events and issues to watch:** India has Jun PMI-mfg due on the 1st. May industrial production and Jun CPI are due on the 12th. May trade is due anytime within 8th-15th, WPI on 14th. WPI is due on the 16th. 1Q BOP current account balance will be released anytime within Jun.

- **Technical Outlook: The past week has been a bearish one for USDINR but stochastics are rising from oversold conditions.**

Last seen around 67.50, this pair is still within an upward sloping trend channel and we see potential upside risks. Support however is seen around 67.10 (21-DMA) before the year low of 66.07. Rebounds to meet barrier around 68.10.

VND: Watching the US Presidential Elections Next

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/VND	22400 (22600)	22600 (22800)	22700 (22800)	22800 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Jun turned out to be a stable month as Fed decided on a cautious hold for Fed Fund Rate. Even Brexit hardly moved the USDVND, allowing the currency pair to arrive at our 2Q forecast of around 22300. This was in spite of the fact that local banks and subsidiary of foreign banks have started to lend dollar loans to export companies. Markets are seemingly calm at this point but the true impact of Brexit is yet to be known. Trade exposure to UK is not material but more concerns are on the EU-Vietnam FTA. The EU Ambassador has assured that negotiations have concluded and the implementation could be in early 2018 as scheduled.

- Medium term, Vietnam's apparel, footwear, agro-forestry and seafood industry still stand to get the boost from the Trans Pacific Partnership. We have seen the surge in FDI and the second order boost on export earnings should be evident by the end of the year. That could continue to strengthen the VND. **Key risk to this medium term view is a surprise Donald Trump win at the Presidential Elections that may jeopardize the Trans Pacific Partnership and reverse the FDI flows that have benefitted Vietnam thus far this year.**

- Whilst we have stated our enhanced dollar strength view, the dollar strength may not be manifested so much against the VND as risks of a FFR hike has reduced. We also take into account resilience exhibited by VND and less depreciation for VND towards 22600 by the end of this year.

- **Growth and Inflation Outlook:** PMI-mfg rose to 52.7 in May from previous 52.3, a 12-month high. The headline was underpinned by strong output increases and persistent rise in new orders. The reading boost confidence in the manufacturing sector although foreign direct investment seems to have lost traction in Jun ahead of risk events such as the UK referendum. Industrial production saw slight deceleration to 7.4%y/y in Jun from previous 7.8% due to a steeper drop in Mining & Quarrying and slower output growth from the electricity sector. GDP growth steadied at around 5.52%y/y for Jan-Jun from previous 5.46%y/y. This was under the consensus of 5.83%. Growth seems resilient despite a drop in farming output due to drought and a toxic spill that affected fishing output. That could lend support to the VND.

- Retail sales quickened to 9.5%y/y in Jan-Jun from 9.1% in Jan-May, underpinned by strong performance in tourism, services and trade and hotel/restaurants. Trade deficit narrowed to just -U$100mn. The May number was also revised lower to -U$177mn. Better trade balances coupled with capital inflows via foreign direct investment should continue to support the dong. As we had mentioned, the outlook for Vietnam's external sector is not marred by Brexit, at least not at this point and could see improvements at the end of the year. We think the result of the US Presidential elections later this year might have more impact Vietnam's exports. For now, growth trajectory is still quite robust for the country with a trade pact coming up with the EU that could increase the FDI flows. Manufacturing sector will continue to be the darling of investors.

- Our Vietnam team has highlighted that near term impact could be via a stronger Japanese yen as Vietnam's external debt/GDP stood at 41.5% as of end 2015. Strong relationship with Japan suggests that JPY-denominated debt could be at least 30% of total debt and a stronger JPY could weaken Vietnam's debt position. That said, given the threat of BOJ intervention and easing, JPY strength seems pretty much curbed. That should in turn alleviate pressure on Vietnam's debt.

- **Monetary Policy Forecast:** SBV has not moved policy rates for a while and we think the cental bank has a lot of room to ease should EU contagion of Brexit deteriorate. The central bank has been keeping the daily USDVND reference rate rather stable. That should continue to keep the USDVND stability this year. With exports still keeping a positive growth, Vietnam's export sector has been outperforming its peers. As we look for enhanced dollar strength, expect Vietnam's robust external position to allow SBV to keep USDVND stable notwithstanding the relaxation of the curbs on dollar lending to export companies.

- Despite the already stellar growth numbers, it is still under expectations. We see slight downside risk to Vietnam's growth target of 6.8%. However, firmer inflation rate as higher food costs may be higher hurdles for a rate move. At this point, we do not expect any rate move in the near-term (currently base rate at 9.0%, refinancing rate at 6.5% and discount rate at 4.5%).

- **Latest Fiscal and External Balance Outlook:** We still eye more infrastructure projects. Inflation is capped at 5% and the budget deficit capped at 4% of GDP. Fiscal room for further expansionary measures may be limited as fiscal expenditures have been outpacing that of revenue in recent years. The recently revised Budget Law meant to take effect from FY2017 is meant to guide the fiscal deficit below 4% of GDP from 5% in 2015.

- Whilst Vietnam's external balance is expected to weaken this year on weaker exports, growth of exports remain positive for the past five months at around 5.0%y/y and that speaks volume of its competitiveness given the high base and sluggish external demand that has impacted most of the region. Current account recorded a surplus of USD1.077bn in 4Q (latest data available). Strong FDI and potential improvement on the external front could keep the VND stable and we have upgraded the dong forecast to 22600 against the USD for the end of the year.

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

FX Forecasts

	End Q3-16 f	End Q4-16 f	End Q1-17 f	End Q2-17 f
USD/JPY	104.00	106.00	107.00	109.00
EUR/USD	1.0700	1.0700	1.0600	1.0800
GBP/USD	1.2500	1.3000	1.3000	1.3000
AUD/USD	0.7200	0.7200	0.7200	0.7400
NZD/USD	0.6850	0.7000	0.6900	0.7200
USD/SGD	1.3750	1.3850	1.3900	1.4000
USD/MYR	4.1000	4.0000	3.9500	3.9500
USD/IDR	13400	13300	13200	13200
USD/THB	36.50	37.00	37.00	37.20
USD/PHP	47.50	47.80	47.50	47.50
USD/CNY	6.65	6.67	6.70	6.70
USD/HKD	7.80	7.80	7.80	7.80
USD/TWD	32.40	32.40	32.80	32.80
USD/KRW	1185.00	1170.00	1180.00	1180.00
USD/INR	68.50	69.50	70.00	70.00
USD/VND	22400	22600	22700	22800
SGD Crosses	**End Q3-16 f**	**End Q4-16 f**	**End Q1-17 f**	**End Q2-17 f**
100 JPY/SGD	1.3221	1.3066	1.2991	1.2844
EUR/SGD	1.4713	1.4820	1.4734	1.5120
GBP/SGD	1.7188	1.8005	1.8070	1.8200
AUD/SGD	0.9900	0.9972	1.0008	1.0360
NZD/SGD	0.9419	0.9695	0.9591	1.0080
SGD/MYR	2.9818	2.8881	2.8417	2.8214
SGD/IDR	9745	9603	9496	9429
SGD/THB	26.55	26.71	26.62	26.57
SGD/PHP	34.55	34.51	34.17	33.93
SGD/CNY	4.84	4.82	4.82	4.79
SGD/JPY	75.64	76.53	76.98	77.86
SGD/HKD	5.67	5.63	5.61	5.57
SGD/TWD	23.56	23.39	23.60	23.43
SGD/KRW	861.82	844.77	848.92	842.86
SGD/INR	49.82	50.18	50.36	50.00
MYR Crosses	**End Q3-16 f**	**End Q4-16 f**	**End Q1-17 f**	**End Q2-17 f**
EUR/MYR	4.39	4.28	4.19	4.27
JPY/MYR	3.94	3.77	3.69	3.62
MYR/HKD	1.90	1.95	1.97	1.97
MYR/CNY	1.62	1.67	1.70	1.70
GBP/MYR	5.13	5.20	5.14	5.14
AUD/MYR	2.95	2.88	2.84	2.92
NZD/MYR	2.81	2.80	2.73	2.84
MYR/IDR	3268	3325	3342	3342
MYR/INR	16.71	17.38	17.72	17.38
MYR/KRW	289	293	299	299
MYR/PHP	11.59	11.95	12.03	11.69

Source: Maybank FX Research as at 30 June 2016.
*These forecasts are meant to be indicative of FX trends and not meant to be point forecasts.

Disclaimers

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