Jun 30, 2017

Macro | FX Research & Strategy

Global

FX Monthly

2017, Issue 6: Will Policy Normalisation Gain Momentum?

What Has Changed This Month?

- We revised JPY (weaker) and SGD, THB, CNY, VND, AUD, EUR and GBP (stronger) in our forecasts. The USD DXY forecast is also calibrated slightly lower accordingly as a result of the combined changes above on the index. Some downward adjustments to the JPY vs. USD, due to medium term improvement in the global risk environment. We expect USDJPY to climb higher to 115, 117 by end 3Q and 4Q 2017, respectively.
- We adjusted the 3Q USDCNY forecast lower towards 6.80 as we see increasing central bank efforts to support the CNY ahead of the 19th Party Congress. However, we are keeping the upside trajectory as we see risks of a sharper run-up towards 6.87 by year end.
- We revised GBP forecast slightly higher to take into account the recent shifts in BoE MPC stance which could result in potential BoE tightening this year.
- We also revised AUD higher given the lesser drag on the USD in the near-term. Healthy demand for base metals (in particular iron ore) should continue to underpin the AUD towards our year end forecast of 0.80.

Our Strategies

- Policy normalization has gained momentum in the US. The June meeting suggests that the Fed is determined to tighten monetary policy further this year with one more hike plus balance sheet reduction. **Our house view is for a 25bps rate hike, likely in Sep and balance sheet reduction to start as early as Oct.**
- As markets continue to price out political risk premium and with the recent change in ECB Draghi's stance on inflation and monetary policy, we see more support for the EUR. Relative to BoJ (the other central bank on easing bias), it is more likely for ECB to move earlier than BoJ in terms of removing monetary stimulus. **We hold our long EURJPY view, as one of our strategic trade for 2017 on receding political risks and to position for eventual monetary policy divergence.**
- Amongst AXJs, we are positive on the MYR given the recent initiatives from BNM. We expect foreign investors' confidence to gradually return. **We see scope for Ringgit to play catch up with regional peers and potentially extend its gains further towards 4.25, 4.20 levels (vs the USD) in June. Prefer to long the MYR, IDR, SGD against PHP, JPY.**
- If UST yields start to rise, we would suggest **USDJPY (target 116, 118) on sensitivity to UST yields rising. While fundamentally, we could short PHPINR on diverging current account balances,** although if oil stabilises currencies of oil importers such as INR and KRW could weaken.
- In an environment of USD strength, CNY should outperform JPY, SGD and KRW in the near term (1 month or less). We look for JPYCNH to head towards 5.82 (50% Fibonacci retracement of the 2015-2016 rally). Look for SGDCNH to head lower towards 4.78 (200-DMA), spot reference at 4.990. We also expect CNHKRW to head higher towards 171.50. Spot reference at 166.20. Stop loss at 163.50.

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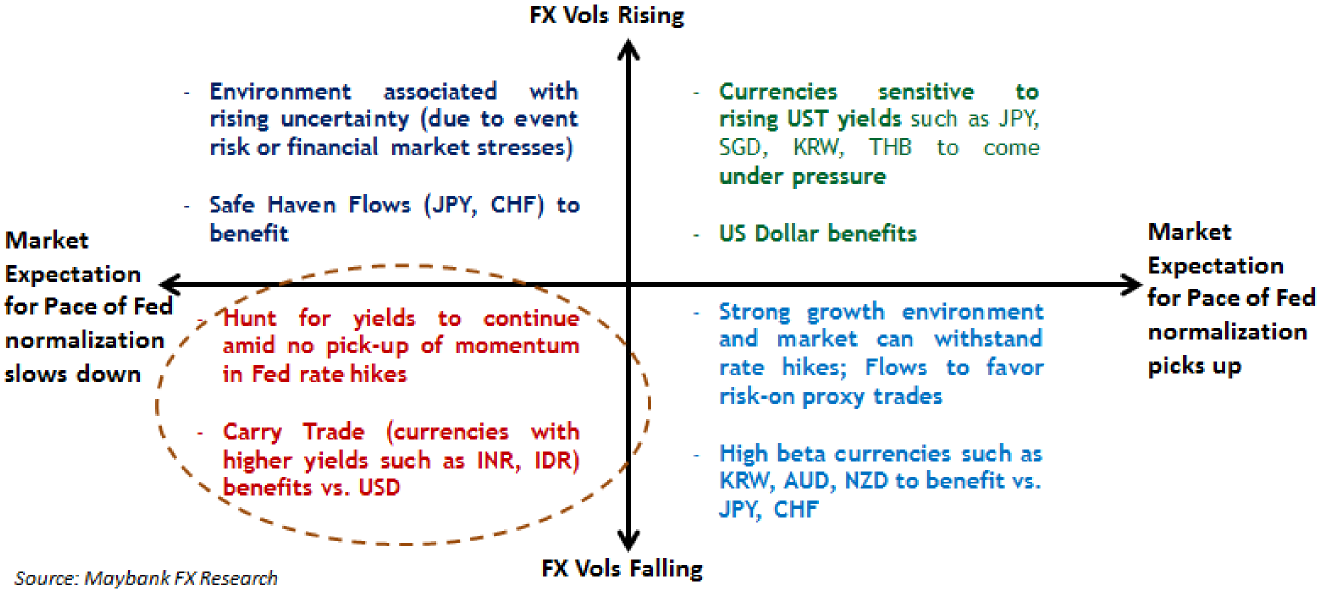
SEE PAGE 57 FOR IMPORTANT DISCLOSURES.

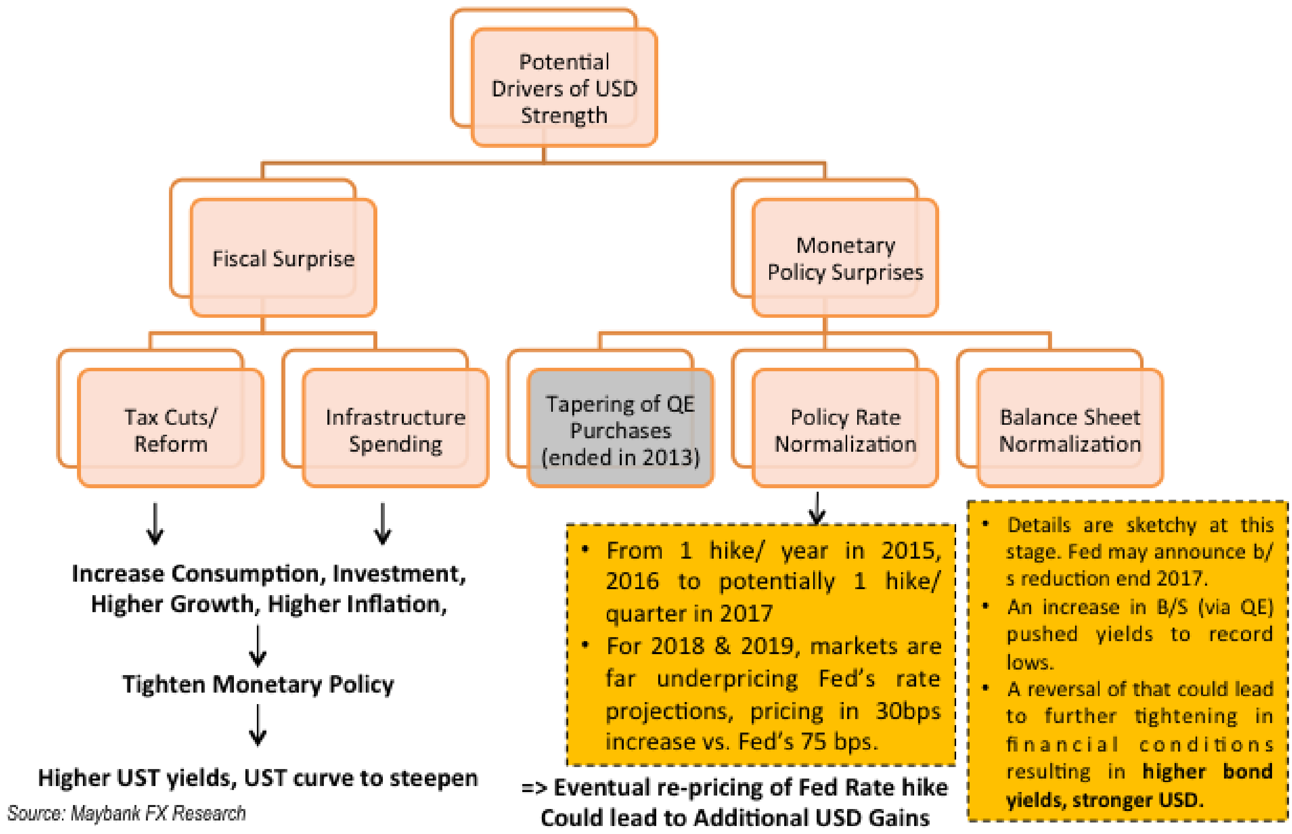
So What?

In the short to medium term, FX Vols and Pace of Fed Rate Hikes are Determinants to FX Bias, Current Environment Favours: INR, IDR



Source: Maybank FX Research

Where Can USD Strength Come From?



Source: Maybank FX Research

G7 Global Overview

USD: Will Policy Normalisation Gain Momentum?

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USD Index	98.09 (102.06)	97.70 (101.50)	97.05 (99.95)	97.97 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We expect at least one more rate hike in 2017, more likely in Sep followed by the start of the balance sheet reduction in 4Q 2017 (possibly as early as Oct 2017). We do caution that additional repricing of a surprise balance sheet reduction over the course of the year 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 FOMC** meetings. The DXY forecasts saw downward revisions due to our upward revisions to the EUR and GBP forecasts despite our upward revisions to USDJPY.

- We continue to expect domestic data and a repricing of the future stance of monetary policy to support the USD. But given further delays in the US tax reforms (possibly in middle of 2018) and trade policies to support a strong US reflation view, we do not expect the Dollar to appreciate as strongly as expected in 2017. **Nonetheless d**uring this phase and around FOMC announcements, we believe the **USD could still be mildly supported at times given potential concerns about Fed changes in FFR guidance on hikes and balance sheet normalisation**.

- **Growth and Inflation Outlook:** The third reading of Q1 GDP saw a upward revision to 1.4% q/q saar versus 1.2% in the previous release. The main source of the upward revision came from personal consumption (again), which was revised higher to 1.1% (from 0.6%). Exports were also revised higher to 7%q/q from 5.8%. Inventories detracted 1.1ppt from growth in the first quarter, more than the previous reading.

- The third reading suggests that private consumption is stronger than earlier estimates and is the main driver of the economy. However, momentum is still slowing from previous quarters. The labour reports for the past two months (Apr and May) have been reasonably healthy with unemployment rate slipping to 4.3%. Average hourly earnings rose 0.2%m/m and 2.5%y/y in May, supportive of household consumption.

- Non-farm payrolls rose by 138k in May, with the private sector adding 147k and the government sector declining 9k. The headline is below the 175k-200k range. The deceleration was quite broadbased. Earnings growth was also soft in May, with average hourly earnings up only 0.2%m/m and 2.5% y/y, slightly lower than expected. The household survey also showed weaker employment growth, with employment declining 233k in May.

- US CPI inflation in May fell 0.1%m/m and rose 1.9% y/y, slowing from 2.2% previously. Core inflation was weaker than expected, rising only 0.1%m/m and 1.7% y/y. Due in part to lower energy prices after increasing in April. Food prices continued to increase at a decent pace as food commodities have continued to recover from 2016. Core CPI fell due to lower domestic prices such as used vehicles, new vehicles and apparel. The support from a stronger dollar and weaker commodity prices in 2015 and 2016 have faded by now and thus this weakness could not be driven by external factors. We should expect headline CPI to reach 2.0% by end 2017 and around 2.5% by end 2018.

- **Monetary Policy Forecast:** Fed funds rate (FFR) upped +25bps to 1.00%-1.25% at 13-14 June 2017 FOMC, second Fed rate hike this year after the +25bps increase at 14-15 Mar 2017 FOMC meeting. No change in Fed's guidance of three hikes this year. Fed also announced gradual balance sheet reduction to start later this year. We expect the third +25bps hike at 19-20 Sep 2017 FOMC, followed by the start of balance sheet reduction in 4Q 2017, possibly as soon as Oct 2017.

- Tweaks in Fed's unemployment & inflation forecasts Fed's real GDP growth forecasts are unchanged i.e. 2.1% for 2017-2018 and 1.9% for 2019. However, unemployment rate projections are lowered to 4.3% this year and 4.2% in 2018-2019 vs 4.5% previously for 2017-2019. Inflation rate (based on Fed's preferred measure i.e. private consumption expenditure (PCE) deflator) for 2017 is cut to 1.6% from 1.9% previously, but Fed maintained its outlook that inflation will reach its "target" of 2% in 2018-2019.

- The FOMC's median forecast for FFR at end-2017 remains at 1.375% (midpoint of 1.25%-1.50%), and there are no changes to the FFR guidance of 2.125% (mid-point of 2.00%-2.25%) at end-2018 and 3.00% (mid-point for 2.75%-3.25%) at end-2019, indicating +75bps hikes per annum or three +25bps increases per year for 2017-2019 (Figure 3). Based on fed fund futures, market have priced in three rate hikes this year, but expect only one hike in 2018 and 2019 respectively (Figure 4), primarily reflecting the divergence between Fed's outlook and market's view on inflation.

- The highlight of this FOMC meeting is Fed's announcement that it will start "balance sheet normalization" this year. Fed will reduce the securities holdings in its balance sheet accumulated from the previous three rounds of asset purchase programmes (quantitative easing or QE) by gradually decreasing the reinvestment of principal payments from matured securities. Currently, Fed fully reinvests the proceeds from matured securities which keeps its balance sheet size at USD4.4tr since Sep 2014 following the end of QE Taper. Fed will start cutting its balance sheet size by an initial US10b per month (i.e. USD6b in US Treasury and USD4b in agency debt and mortgagebacked securities). It will increase the pace of reduction by +USD10b every three months (i.e. +USD6b in US Treasury and +USD4b in agency debt and mortgage-backed securities) over a 12 months period until the monthly balance sheet reduction reached USD50b per month (i.e. USD30b in US Treasury and USD20b in agency debt and mortgage-backed securities), which Fed expects to be the maximum pace of monthly balance sheet reduction for a gradual and predictable balance sheet normalization process. Based on this information and our calculation (Figure 5), the cumulative amount of balance sheet reduction in the first year of this balance sheet normalization process will be USD340b, which is 7.7% of the current balance sheet size of USD4.4tr. The missing details are when exactly will the process start, and what is the ultimate balance sheet size.

- Even with the indication of the balance sheet normalisation starting this year, the provisos include interest rate hike that is well under way - underscoring FFR as the main tool of the on-going monetary policy normalisation, and the economy that is evolving as expected i.e. sustainable growth momentum, further strengthening of labour market and inflation approaching 2%. As for the ultimate size of its balance sheet, Fed expects the balance sheet size to drop to a “level appreciably below that seen in recent years but larger than before the financial crisis”. To note, just before the start of QE, Fed’s balance sheet size was around USD900b.

- Former Fed Chair Ben Bernanke wrote in Jan 2017 that a “minimalist” Fed’s balance sheet would be reflective of just currency in circulation, which today is around USD1.5tr, which Fed staff forecasts will increase to USD2.5tr over the next decade. The growth of currency in circulation alone confirms Fed’s balance sheet will end up larger than the pre-GFC/pre-QE levels despite the balance sheet normalisation process. Bernanke added that the size of Fed’s balance is also determined or influenced by other factors like the rise in nominal GDP, foreign demand for US Dollar, as well as the optimal level of bank reserves and other non-currency component of the balance sheet (which are important in the conduct - and as tools - of Fed’s monetary policy). What next for the Fed? We expect Fed to deliver the third +25bps hike at the 19- 20 Sep 2017 as well as officially announce the start of the balance sheet reduction in 4Q 2017, which could be as soon as Oct 2017.

- But any substantive deceleration in data this year, and we could see Fed step back toward their more dovish bias. The fiscal stimulus this year if it materializes is the main factor likely to support growth but with the NFP showing deceleration rather than acceleration and if the weakness continue, if Congress disappoints by failing to implement the fiscal stimulus, monetary policy could be more dovish and weigh the USD lower.

- **Latest Fiscal and External Balance Outlook:** Fiscal policy should be expansionary over the next few years as the tax reforms take shape and some investment in infrastructure becomes apparent under the Trump administration. The deficit has fallen sharply from its peak. Fiscal sustainability risk continues to weigh on the outlook and may emerge sooner than later. 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 2018. The US other deficits - current account and BOP deficits have moved slightly wider and is expected to continue.

- **Key domestic events and issues to watch in July 2017:** Key US events: ISM Manufacturing (3 July); Factory Orders (5 July); Durable

Goods Orders (5 July), FOMC Meeting Minutes for June (6 July); NFP (7 July); CPI (14 July); Retail Sales (14 July); FOMC (27 July); GDP 2Q (28 July), PCE Deflator (28 July).

Technical Outlook: DXY traded to fresh 8-month low of 95.68 (29 Jun) amid the surge in EUR, GBP. Last seen at 95.60 levels. Bearish momentum on weekly and daily charts remains intact but weekly stochastics suggests DXY in in oversold conditions. Rebound risks ahead. Resistance at 97.15 (61.8% fibo retracement of Jul low to Dec high), 98.40 (50% fibo). Key support at 95.60 (76.4% fibo). We caution that a break below key at 95.60 could see a big move lower towards 93-levels.

EUR: A Shift in ECB Stance, Soon?

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
EURUSD	1.1250 (1.0700)	1.1400 (1.0800)	1.1500 (1.1000)	1.1300 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** We see **room for EUR to gain further** as (1) political risks in Europe recede (Macron's strong win at Legislative election in Jun seen as a defeat to Euro-sceptic and investor confidence is gradually returning); (2) sustained signs of economic recovery broadening in Europe; and (3) and increasing signs that ECB may signal some removal of monetary stimulus in due course if inflation continues to tick higher. ECB Draghi's comments that deflationary forces is gone and reflationary forces are at play and his take that the factors weighing on the path of inflation were mainly temporary and the ECB can look through suggest a shift in ECB's bias. We revised our EUR forecast higher to take into consideration this recent development. We expect EUR's trading range profile to shift higher into 1.11 – 1.15 for the next few weeks. Bias to buy EUR on dips.
- That said **we do caution there are risks that could limit EUR's gains, but these are likely to be temporary factors** – (1) Upcoming German Federal election in Sep should warrant some caution as election campaign may intensify as we get closer to election day and may temporarily swing sentiment and the EUR (though we do note that polls and election forecast models currently indicates that Merkel remains in the lead); (2) risk of Italy calling for early elections – and could dampen investor sentiment, heightens political uncertainty and weigh on EUR (previously there were talks that Italy may hold its elections the same day as Germany); (3) markets' over-expectation for ECB to remove monetary stimulus may be met with disappointment (excessive EUR longs may catch markets off-guard and result in EUR long positions being pared-back) as ECB may proceed in a slow and cautious way. ECB's Draghi had repeatedly urges persistence in stimulus as he believes a considerable degree of monetary accommodation is still needed for inflation dynamics to

become durable and self-sustaining (27 Jun speech at ECB Forum). We think there is no urgency to rush to end QE pre-maturely and we believe ECB wants to see inflation becoming durable and self-sustaining (chief mandate). Too strong a EUR could also weigh on imported prices (imported consumer products account for around 15% of industrial goods in the Euro-area) and result in negative feedback loop to core inflation. True that the likelihood of ECB tweaking its monetary policy stance has risen, this however does not constitute to monetary tightening unlike the Fed, which is in the midst of raising rates and on the cusp of reducing its balance sheet.

- **EUR could trade higher towards our medium term fair value of around 1.1650 over time if ECB's monetary policy divergence with the Fed slows or even converge with the Fed over time**. We believe Euro-area needs deeper structural reforms in government debt and labor market to lift long term growth potential and push EUR meaningfully higher above 1.20 but pushing through policies within the Euro-area are often complicated and challenging. Besides, if Brexit materializes, EU will be losing its second largest economy (representing 18% of its GDP and 13% of its population).

- **Risk to our outlook: EUR may face renewed downside pressure stemming from monetary policy divergence if Fed tightens monetary policy more aggressively than expected**. The recent FoMC meeting (15 Jun), Fed Chair Yellen and Dudley's speech (19 Jun) suggested a more hawkish Fed (than what markets expected) that seems determined to normalize monetary policy. Fed retained its forward guidance (our house view for 25bps hike in Sep-2017) and detailed balance sheet reduction plans (our house view for Fed to begin balance sheet reduction as early as in Oct). Fed Chair Yellen's dismissal of the moderation in price pressures as transitory and believes that the tightness in labor market should translate into higher wage cost going forward. We believe upside surprise to US inflation could make the case for markets to re-positioning for higher UST yields and wider Euro-UST bond yield differentials could weigh on EUR.

- **Growth and Inflation Outlook:** Euro-area recovery continues, with quarterly growth expanding at its fastest pace since 2015. 1Q GDP was revised higher to 0.6% q/q (vs. 0.5% in first reading) owing to better than expected performance in France, Italy and Greece. All 19 Eurozone member registered positive growth while unemployment has also fallen to its lowest level (9.3%) since 2009.

- Jun PMIs did show a pullback in services sector but manufacturing activity remains on the rise (highest level since 2011). Taken together, the slight moderation in composite PMI should only be treated as a mild pullback as survey readings remain in expansionary territories and consumer confidence level is at 16-year high.

- In the last quarterly assessment report (8 Jun), ECB modestly revised 2017 and 2018 growth to 1.9% and 1.8% (from 1.8% and 1.7%), respectively. ECB acknowledged that risks are now "broadly balanced" (a shift from "tilted to the downside" in last ECB statement) and there is stronger momentum in the Euro-area economy.

- **Euro-area inflation slowed in May,** with headline CPI decelerating to 1.4% y/y (vs. 1.9% in Apr), owing to decline in energy costs and services. Core inflation held steady at 0.9% y/y in May. These data confirmed ECB Draghi's worries that core inflation has yet to see a meaningful recovery. In Draghi's words, for inflation to be considered as 'sustained adjustment', there are four elements that need to be fulfilled: Inflation (1) is affecting the medium term, (2) is durable, (3) is self-sustained and (4) is region wide. So far it remains too soon to conclude that the the four elements above are met as core inflation continued to hold around 1% y/y and is not showing any signs of uptick. 5y5y EUR inflation swap has trended lower since start of the year - an indication of fading price pressures.

- **But the ECB's Draghi now says temporary factors are weighing on the path of inflation and the central bank can look through it.** At the ECB forum (27 Jun), Draghi attempted to explain that understanding inflation dynamics involves dividing the inflation process into 2 legs: the effects of monetary policy on aggregate demand and the effect of aggregate demand on inflation. He then went on to point to evidence suggesting that the first leg is working well: Euro-area enjoyed 16 quarters of growth with 6.4m jobs created since the recovery began. He then shared that the second leg of the inflation process – the transmission of rising demand to rising inflation has been more subdued than in the past and there are several factors weighing on the path of inflation, including (1) external shock to energy and commodity prices depressing cost of imported energy and producer prices; (2) size of output gap and its impact on inflation; (3) extent to which current period of persistent low inflation feeding into price and wage setting in a more persistent way and that these factors have been relevant for the delayed reaction of inflation to the recovery. And **Draghi said these are mainly temporary factors that typically the ECB can look through. He added that the threat of deflation is gone and reflationary forces are at play** but at the same time he also urges persistence and prudence in monetary policies – maintained that a considerable degree of monetary accommodation is still needed for inflation dynamics to become durable and self-sustaining

- In the last quarterly assessment report (8 Jun), the ECB revised inflation forecast lower to 1.5% for 2017 (vs. 1.7% in prior report) and to 1.3% for 2018 (vs. 1.6% in prior report) despite acknowledging the strength of the Eurozone's accelerating economic growth. The downward revision was due to lower oil and food prices

- **Monetary Policy Forecast:** We expect ECB to keep monetary policy status quo at the upcoming meeting on 20 Jul, after its decision (back in Dec 2016) to extend QE (at a reduced pace of €60bn per month) till end 2017. **We reiterate that the ECB will stick to its accommodative stance and not rush to call for further tapering, since core inflation has yet to see a meaningful recovery. There is however some risk of ECB discussing further QE tapering at the 7th Sep meeting** (3 months prior to the end of QE) should growth and inflation data firms.

- At the last ECB meeting (8 Jun), Draghi reiterated that tapering of QE was not discussed at the meeting and ECB remains unconvinced that inflation is showing signs of sustained pick-up. But the **forward guidance was tweaked slightly - It now says rates will only stay at their present lows should inflation continue to undershoot (vs. taking interest rates below their record levels if warranted).** The ECB's QE programme could however still be expanded beyond its €60bn a month "if necessary".

- To recap, QE was extended beyond Mar 2017 for another 9 months to end-2017, at a reduced pace of €60bn per month. There were also a handful of technical tweaks to the APP to ensure smooth implementation of the program. Our take is ECB's monthly purchase after Apr 2017 may seem like a tapering at first glance but in actual fact, the option chosen between the 2 (either €80bn per month for 6 months or €60bn per month for 9 months) implies a larger QE amount (€540 bn). This implies ECB is still far from tapering and is expected to remain on easing bias.
- **Latest Fiscal and External Balance Outlook:** Euro area's current account surplus narrowed to EUR22.2bn in Apr (from EUR35.7bn in Mar), owing to widening shortfall on secondary income. Current account surplus is at its lowest level in more than 2 years. That said surplus to GDP remains at 3.2%.
- 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.
- **Key domestic events and issues to watch:** May unemployment rate (3 Jul); May PPI (4 Jul); May Retail sales (5 Jul); May UP (12 Jul); Jun CPI (18 Jul); ZEW survey (18 Jul); May Current account (20 Jul); ECB Meeting (20 Jul); Jul flash PMIs (24 Jul); Jul consumer confidence (28 Jul); Jul CPI estimate (31 Jul).
- **Technical Outlook:** EUR has traded higher, especially over the past few days (last week of Jun) amid comments from ECB's Draghi. The move higher has also broken many key resistances. Pair was last seen at 1.14 levels. Monthly, weekly, daily momentum indicators have turned bullish but stochastics on weekly chart is in overbought conditions. While the uptrend stays intact, we see risk of correction from recent euphoria. Prefer to buy on dips towards support levels at 1.13, 1.1210 (23.6% fibo retracement of 2014 high to 2016 low), for a move higher. Resistance at 1.1460, 1.1620 levels.

GBP: Itching for a Rate Hike?

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
GBPUSD	1.3200 (1.2600)	1.3000 (1.2800)	1.2900 (1.3000)	1.3200 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View**: With domestic politics taking a temporary back seat for now (thanks to agreement between Conservative and DUP and fear of second election receded), we expect markets to shift its focus to the risk of BoE tightening (2Y UK-UST yield differentials started to narrow) given recent shifts in BoE MPC members and the reinstatement of counter-cyclical capital buffer. And it could be as early as at the next meeting (3 Aug) that the BoE could tighten. This should see stale GBP short positions getting washed out further and keep GBP supported. While GBP could trade higher amid speculation for BoE tightening soon, we expect the topside to stay capped around 1.31 levels as uncertainties around *Brexit remain* and deceleration in growth momentum is likely to persist. For the month of Jul, we expect GBP to trade in higher range of 1.27 – 1.31 (vs. 1.2590 – 1.2980 range in Jun). We revised our GBP forecast higher to take into account recent development.

- **BoE to Tighten in August?** We acknowledge that markets are increasing their bets that BoE may proceed with raising policy rate at their next meeting (3 Aug). This comes off the back of recent developments including (1) the swing in MPC vote (22 Jun BoE meeting) leaning towards the hawkish camp; (2) rising inflation (which seems to test the tolerance of several BoE policymakers, including outgoing member Kristin Forbes and Chief Economist Andy Haldane; (3) recent policy changes (Financial Stability Report on 27 Jun) where counter-cyclical capital buffer was being reinstated at 0.5% (up from zero) and signaled its intent to increase it again to 1% in Nov (Recall that back in Jul-2016 in the aftermath of Brexit, the capital buffer’s cut to zero came as a prelude to BoE rate cut and QE in Aug-2016, which saw GBP under pressure. A capital buffer hike on 27 Jun sparked off speculation that perhaps a rate hike is forthcoming); and (4) recent BoE Governor Carney’s comments that he would vote to tighten monetary policy if business investments begin to rise and offset weaker consumption (indeed 1Q GDP breakdown by expenditure showed mixed signals - household consumption declined while investments picked up). 2Y UK bond yield has jumped more than 50% (albeit from low base) to 0.336%, from a low of 0.04% (back in Mar 2017). UK-UST yield differentials have also started to narrow to -100bps (vs. -130bps back in Mar-2017). Further narrowing of yield differentials could lend support to the GBP. Markets positioning (via OIS-implied) shows a shift in expectation for BoE to raise rates as early as in Nov-2017, from Feb-2018. For Aug-2017 BoE meeting, market sees a 25% chance of rate hike, up from 15% chance. **Our base case scenario remains for BoE to remain on hold but we**

see rising likelihood of BoE raising rate from record low of 0.25% to 0.50% at the upcoming meeting but the pace of tightening will not be aggressive (if BoE were to tighten). We will adjust our base case scenario if upcoming data - business investments and wage growth firm further.

- *Brexit* negotiations have already started on 19th Jun and the Chief negotiators of Britain (David Davis) and EU (Michel Barnier) agreed that the **immediate priorities (from now to Oct) is to focus on citizen rights, a financial settlement and other separation issues with a separate dialogue on N. Ireland.** Further talks are scheduled in the weeks starting 17-Jul, 28-Aug, 18-Sep and 9-Oct. Trade talks will only be allowed after a deal on citizens' rights, money and Irish borders have been agreed. The schedule does suggest some clarity on Brexit negotiations timeline over the next 4 months but much uncertainty relating to whether London still hold as a financial hub, if investments inflows will slow and lead to weaker labor market or if jobs get relocated, remain unknown. Recent development saw Nomura and Daiwa picking Frankfurt as its post-Brexit HQ and will move jobs out of London. Previously Deutsche Bank had said that up to 4,000 UK jobs could be moved to Frankfurt. JP Morgan, UBS and Goldman Sachs also mentioned moving staff out of London. Certainly these job losses have yet to materialise and may still be at early stages but eventually when consideration translates into decision, the pain will be felt and GBP is expected to bear the brunt of the painful *Brexit* consequences.

- Domestic politics take a back seat as a deal based on confidence and supply has finally been reached between the Conservatives and N. Irish's DUP. Basically the parties agree to keep pensions triple lock; keep winter fuel payments for pensioners without means-testing; agree to retain NATO commitment to spend 2% of GDP on defense; Central government agrees to GBP1b of funding to N. Ireland. The DUP will back the government on legislation pertaining to national security; support government on all motions of confidence, Budget, finance bills and appropriation while support on other matters will be agreed on case by case basis. The agreement will remain in place for the length of the government. Fear of a second election being held has now subsided and eyes will be on Conservative Party Conference (usually end Sep to early Oct) – if PM Theresa May's leadership could be challenged given the lackluster performance at the General Election on 8th Jun.

- We maintain our medium term (18 - 24month) bias that GBP could trade higher from current levels towards 1.35 – 1.40 as GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40). The 20% or so depreciation since referendum results (Jun 2016) should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We believe UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term). Past experience of UK leaving the ERM back in 1992 saw a period of consolidation (for a few years) at historical lows for

GBP, before the eventual move higher in the following years, where GBP TWI traded above 100-levels in 1998 (from the lows of 80 in 1993-1996) due to buoyant demand fueled by rapid growth of wealth, credit and money. If history is a guide (assuming UK manages the transition well and takes the opportunity to correct its imbalances), its currency may start climbing higher.

- **Growth and Inflation Outlook: UK economy growth momentum slows further.** industrial, manufacturing production and construction output all shrank in May. Composite PMI also moderated in May, dragged by the moderation in services and manufacturing activities. Retail sales also posted a sharp decline (-1.6% m/m) in May, in line with our caution that slowing wage growth and rising inflation will compress real wages, crimp household budget and limit discretionary spending. 1Q GDP also slowed to 0.2% q/q (vs. 0.7% in 4Q 2017). This is the slowest in a year. Taken together, the downside surprise to economic data remains consistent with our call and we expect downside surprise to persist in the months ahead (but we stop short of painting a gloom and doom scenario).

- **UK inflation jumped to fresh 4-year high** of 2.9% May, from 2.7% in Apr due to increase in prices for package holidays, computer games and laptops. Inflation overshoot is above BoE's target of 2% and is increasingly testing the tolerance of some BoE policymakers. Outgoing MPC member Kristin Forbes reiterated in her speech that there is some urgency in tightening monetary policy as inflation is likely to remain above the 2% target for at least 3 years (22 Jun). Core inflation (ex food and energy) also jumped to 2.6% (from 2.4% in Apr) – a 5-year high. We expect inflation to inch slightly lower in coming months as effects from travel (Easter holiday), fuel prices ease and GBP stabilization from depreciation could stabilize import price pressures.

- **Monetary Policy Forecast: Our base case scenario remains for BoE to remain on hold (**as premature tightening to arrest inflation may upset growth momentum especially in an environment of slowing growth, potential consumer squeeze and *Brexit* negotiation uncertainty) **but we see rising likelihood of BoE raising rate from record low of 0.25% to 0.50% at the upcoming meeting but the pace of tightening will not be aggressive (if BoE were to tighten). We may adjust our base case scenario if upcoming data - business investments and wage growth firm further.** We acknowledged the shift in MPC towards the hawkish camp but **remain little convinced that the balance of the MPC will shift unless data - in particular business investment and wage growth surprise to the upside.** There are currently 8 MPC members (supposed to have 9 members) and MPC member Kristin Forbes (dove) is leaving as her term ends on 30th Jun. She will be replaced by Prof. Silvana Tenreyo as an external member and we will be paying close attention to her speeches to sieve out any dovish or hawkish leaning. In her previous role as MPC member at Bank of Mauritius, she has never voted for a rate hike in the 11 rate decision meetings she participated in. Last year in the FT annual survey of Economists, she said a hard Brexit would have a substantial effect on immigration flows and possibly emigration and the effects on the UK economy will certainly be negative; many firms will need to rethink and reorganize production as they lose talented workers. We think she may well vote for no rate increase at the next meeting. Assuming BoE bank staff sticks to keeping rates on hold, we may see the MPC vote 6-2 to keep rate unchanged. Even if Andrew Haldane (Chief Economist and MPC member) switches for a rate hike – the MPC may still be short of votes to raise rates at the Aug meeting unless BoE Governor Carney switches camp (which is not impossible - Back on 20th Jun, Carney said "now is not yet time to start raising rates as domestic inflationary pressures remain subdued, consumer spending and business investment sending mixed signals while wage growth remains anaemic". But on 28th Jun he said that "tolerance for faster inflation is limited and some removal of BoE stimulus may be necessary").

- At the last MPC meeting (15 Jun), BoE MPC voted 5-3 to keep rates on hold. Markets were expecting MPC to vote 7-1 to keep rates on hold. The camp (Kristin Forbes, Ian McCafferty, Michael Saunders) which dissented noted its "reduced tolerance" of an inflation overshoot and argued that some withdrawal of last year's stimulus is required to moderate inflation overshoot. The other 5 members (voted to keep rate unchanged) argued that it remains too early to rule out a renewed slowdown in growth as the slowdown in household consumption and GDP has recently begun.

- **Latest Fiscal and External Balance Outlook:** UK's budget deficit narrowed in May, owing to recovery in value-added tax receipts. Budget deficit has been greatly reduced to 2.4% of GDP from about 10% of GDP in 2010. Office for Budget Responsibility expects the budget deficit to widen again in 2017-18 due to fewer one-off factors. Borrowing in May was lower due to an increase in central government revenue of £2.6bn or 5.1%, boosted by a 4.3% rise in VAT receipts, that offset higher expenditure of £2.2bn, a rise of 4.2%.

- Debt to GDP ratio is now projected to decline from 88.8% in 2017/18 to 88.5% in 2018/19 and 79.8% in 2021/22. The budget took into account fresh updates to 2017 growth forecast (2%, from 1.4% previously).

- UK's current account deficit to GDP narrowed from about -5% of GDP in 3Q 2016 to -4.3% of GDP for 4Q 2016. Improvement was due to trade deficit narrowing (thanks to increase in exports amid softer GBP)

- **Key domestic events and issues to watch:** Jun Mfg PMI (3 Jul); Jun Construction PMI (4 Jul); Jun services PMI (5 Jul); May IP, trade (7 Jul); May jobs report (12 Jul); Jun CPI, PPI, RPI (18 Jul); Jun retail sales (20 Jul); public finances (21 Jul); 2Q GDP (26 Jul). No BoE meeting scheduled for Jul, next one scheduled on 3 Aug.

- **Technical Outlook:** Our call for GBP to head lower (in last FX Monthly) towards our support levels was met. GBP traded a low of 1.2589 before the sharp rebound in the last week of Jun (thanks to comments from BoE's Carney). GBP was last seen at 1.2970 levels. Bullish momentum on monthly, weekly, daily chart remains intact. Key resistance at 1.3060 (38.2% fibo retracement of 2016 high to low).

Only a decisive break above this will see GBP trending higher towards 1.32, 1.3420 (50% fibo). Support at 1.2860 (50 DMA), 1.28 (21 DMA).

AUD: Nascent Signs of Recovery

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
AUDUSD	0.76 (0.75)	0.80 (0.78)	0.78 (--)	0.78 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** AUDUSD has moved sharply higher, helped by firmer iron ore prices, sluggish USD as well as a concomitant signs of stability in demand out of China. Recent strength in the local labour report certainly helped too but with the wage growth still low, household debt to disposable income still high and more reliance on services sector, a rate hike may not come until we are well into 2018. The firmer AUD could also undermine the exports of services and we are still left with household demand as a key driver of growth as what we have seen in 1Q. Still, with RBA unlikely to move prematurely, we see AUDUSD higher, underpinned by stability in metal prices and less drag from the sluggish USD. We shift our AUDUSD for 3Q towards 0.76 taking into account these considerations. Also, with recent data indicating nascent signs of sustained economic recovery, we feel confident enough to lift our AUDUSD forecast towards the 0.80-level by year-end.

- **Growth and Inflation Outlook:** The trade surplus narrowed in Apr and exports and imports growth slowed in the month. Key metal prices have come off and terms-of-trade is expected to correct from its recent highs of 109.70 recorded for 1Q. That said, data has been turning more positive in recent months with the labour report showing persistent rise in employment growth from 0.80%y/y in Oct to 1.95% in May. Wage growth has been the lowest in history in tandem with unit labour costs that have been negative for the past two quarters. The latter suggests that productivity has fallen in recent quarters. Again, RBA Lowe attributed the low wage growth to concerns of competition from foreign migrants and robots and preference for employment security over huge pay increase. In a recent speech, RBA Lowe emphasized that the distinction between full-time and part-time is outdated and that at some point, workers may ask for larger wage rises. In the meantime, the ratio of household debt to disposable income is still high. Hence, we watch for more data to tell if the recent rebound in retail sales is sustained. Ex-inflation, retail sales eked out a small gain of 0.1%q/q for 1Q, well under the expected 0.5%.

- Capacity utilization rates across sectors (manufacturing, construction, services) firmed in May, above its 5-year average, possibly buoyed by the recent improvement in private consumption. Hiring seems to be stronger in services sector including accommodation, cafes & restaurants, transport & storage, professional, scientific aand technical services, education and training, health care and social assistance. Together with the strong labour reports of late and the rise in retail sales, the second quarter looks more promising than the first notwithstanding the fall in metal prices that are already showing some signs of stability.

- **Monetary Policy Forecast:** We maintain our view for RBA to hold cash target rates at 1.5% for the rest of this year. From the last RBA meeting in Jun, the central bank noted that the labour market "remained mixed" with stronger employment growth accompanied with weak growth in total hours worked. In a latter speech, RBA Lowe reiterated that the distinction between part-time and full-time employment is outdated and that at some point, workers may ask for larger wage rise. That time might come but as noted in the central bank statement, it could take a while before that happens. With wage growth still at record low and expected to remain so for a while, high household debt that could also crimp on private consumption, the signs of recovery that we have witnessed in the labour market, especially in the services sector and possibly some income boosts from export receipts are encouraging but nascent and vulnerable. AUD still dictated by swings in the metal prices, appreciation in the currency could also affect tourist arrivals, spending, crimping on the services sector, wage growth. The transition to an economy that is more reliant on exports of services could mean that wage growth will be weak. That could mean inflation could remain at the lower bound of the 2-3% and the cash target rate is thus more likely to be stuck at 1.50% for a while, at least well into 2018.

- In the meantime, Australian bonds are still in demand as investors continue to favour positive yielding, better quality bonds. The Australian sovereign curve has been bull flattening for much of the year. 10-year was last seen around 2.43%, another 6bps lower from a month ago. With inflation still subdued and mixed outlook on its economic growth trajectory and uncertainties in the labour market conditions, there is an increasing expectation that rate increase will be gradual. That could continue to support the domestic bond demand, especially on the long end. With central banks around the world (with the exception of the US) reluctant to allow rates to run much higher, wholesale funding cost for Australian banks are also likely to be capped for now but we are less sure if this is sustainable once US rates start to rise. Barring any data surprises, AUD is more likely to be driven by other factors like commodity prices, terms of trade rather than policy rate expectations.

- **Latest Fiscal and External Balance Outlook:** As reported last month, the 2017-18 budget deficit is A$29.4bn and projected to return to a surplus of A$7.4bn by 2020-21. Economic assumptions include inflation at 2% this year, real GDP of 2.75%. Total revenue is expected to be A$444.4bn, up from A$412.1bn in 2016-17. Net debt is projected to peak at 19.8% of GDP in 2018-19. Infrastructure spending will amount A$75bn from 2017-18 to 2026-27. More spending also on early learning and childcare via new system of fee subsides. Cuts seen in tourism, public service (diplomats). More revenue is to be generated from visa application, cigarettes levy and taxes on banks' liabilities. The budget managed to help the government avert a loss of its AAA rating by S&P

but uncertainties of its revenue projections saw the rating agency maintain a negative outlook for Australia. Ahead of the budget, the government had put through populist measures including tightening of citizenship rules and curbs on gas exports to ensure domestic supply. These measures might contribute to better ground sentiments in time and allow more room for policy maneuvers to revive the economy before the next election in 2 years.

- **Key domestic events and issues to watch:** M-I inflation, building approvals on 3rd, retail sales on 4th followed by RBA meeting, trade balance on 6th, NAB business survey, home loans on 11th, Westpac consumer confidence on 12th, RBA minutes on the 18th, labour report on the 20th, 2Q CPI, PPI on 26th.

- **Technical Outlook:** AUD bulls are on the roll, underpinned by a sell-off in bond amid hawkish talks by central banks in the developed world. This AUDUSD seems keen to break the 0.77-figure to head towards the year high of 0.7750. Iron ore prices continue to be a strong underpinning as well. Support is seen around 0.76-figure. This antipode is brushing off any caution in the equities and bias remains to be on the upside for a while.

NZD: Fundamentals Supportive but could be at Risk of Downside Correction

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
NZDUSD	0.7300 (--)	0.7500 (--)	0.7700 (--)	0.7600 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** We stick to our call that some degree of downside correction is probably due for NZD, on a combination of reasons including (1) stretched NZD long CFTC positions to 2014 highs (pose downside risk in event of surprise shocks); (2) widening current account deficit (-3.1% of GDP) while NZ-UST yield differentials are at risk of being compressed further (2y NZ-UST differentials at +65bps now vs. +110bps early-2017); (3) risk of debt-to-loan limits being added to RBNZ macro-prudential toolkit (which is undergoing consultation now and could be added as soon as Aug-Oct) and (4) inflation at risk of slippage (2Q CPI data out on 18 Jul) due to continued moderation in construction cost inflation (as building activity slows). We reiterate that we remain broadly positive on NZD owing to solid underlying fundamentals - resilient growth underpinned by tourism and consumer spending, rising budget surplus, etc. and improvement in dairy sector. We believe these fundamental factors should keep NZD broadly supported (above 0.70-0.71 levels).

- A combination of worsening current account deficit amid the compression of interest rate or yield differentials is expected to weigh on the currency.

- NZ's current account deficit widened in 1Q 2017 to $2.8bn (vs. deficit of $1.7bn in 4Q 2016). As % of GDP, current account deficit widened to 3.1% of GDP (vs. 2.7% of GDP prior). The deterioration was due to record high imports (goods deficit widened to levels not seen since 2Q 2008 and came as a surprise as consensus was expecting a surplus of $1bn.
- NZDUSD has largely traded in line with NZ-UST yield differentials but the recent rise in the NZD appears to be out of step with NZ-UST yield differentials. Potential monetary policy divergence between the Fed (determined to normalize monetary policy) and RBNZ (remains on easing bias and is not in any urgency to raise rates) could narrow the NZ-UST yield differentials (2y NZ-UST differentials at +65bps now vs. +110bps early-2017) further and this should weigh on the NZD.

- We also see reasonably high likelihood of potential inclusion of debt-to-income (DTI) limits (likely in Aug – Oct) to RBNZ's macro-prudential toolkit possibly as early as in Aug-Oct this year especially with household debt to income surging to historical high of 167.90% in 4Q 2016. Past episodes of introduction of macro-prudential tools led to lower NZD, and we expect a similar round of effect, if DTI is introduced.

- Apart from short term factors that could weigh on NZD, we find other fundamental factors remain solid and could still keep the NZD supported. For instance NZ's rising budget surplus, we expect the budget plans to boost spending and this could support inflationary pressure and lead to earlier than expected monetary tightening (end-2017 or early-2018). This should be supportive of NZD strength.

- As such we maintain our NZD forecast across the forecast horizon, expecting Kiwi to gradually rise into 1Q 2018, due to RBNZ rate hike expectations and domestic resilience. Our fair value (fast tracking model based on real yield differentials, current account differentials and reflation proxy) puts Kiwi at 0.72.

- **Growth and Inflation Outlook: 1Q GDP growth (released on 15 Jun) disappointed** (+0.5% q/q vs. +0.7% q/q expectation) owing to the contraction in construction sector and mixed results for services sector. Breakdown by industry level showed 11 out of 16 industries increased in 1Q – agriculture (thanks to milk production), accommodation and retail trade outperformed while construction, transport were down. In terms of expenditure level, household consumption saw its biggest increase in over a decade, overall investment also increased owing to strong investment in plant, machinery and equipment (strongest level in nearly 7 years) despite slower building activity while net exports was down. **2Q GDP is scheduled for release on 19 Sep.**

- NZ's economy is expected to continue growing at an average of 3.1% over the next 5 years, according to PM English (25 May). Though NZ construction sector (accounts for 6.5% of GDP) could peak this year as investments in residential building construction slows, activity should remain high and the economy should still be supported by tourism, consumer spending and exports. We continue to expect the NZ economy to outperform most of G7 economies this year.

- **Focus will be on upcoming CPI release (18 Jul) - if CPI continues to sustain its up-move** - after the surprise spike for 1Q CPI into the middle of RBNZ's 1-3% target range. 1Q CPI rose to 2.2% y/y (vs. +1.4% in 4Q 2016). The move higher was driven by fruits/vegetables and cigarettes/tobacco components. This is the first time since 3Q 2011 that CPI has risen above the mid-point of RBNZ's 1-3% target band. RBNZ had written off the jump in headline inflation saying that it was mainly due to higher tradables inflation (petrol and food prices) and is likely to be temporary. Focus is on non-tradables inflation and wage inflation which remain moderate and is expected to increase gradually.

- Recent RBNZ studies also showed that traditional drivers of inflation – high immigration and construction spending – are less inflationary in current episode vs. previous episodes of economic expansion. RBNZ attributed this to two reasons: (1) current immigration cycle has a larger share of younger migrants (17-29 years old) and they tend to

- have a small impact on net demand and inflation than older migrants (Vehbi, 2016)1 and (2) weakness in Australian labor market resulted in higher unemployment and less inflation pressure (Armstrong and McDonald, 2016)2 than if migrants were being drawn by strength of NZ economy or for other reasons. Large construction spending should typically result in rising price pressures. But in the Canterbury rebuild after two large earthquakes in Sep-2010 and Feb-2011, the degree of spillover from construction costs to CPI was much less than expected. According to RBNZ studies, domestic and foreign labour markets as well as immigration policy appear to have been flexible to prevent a dramatic increase in national wages and inflationary pressure. Looking ahead, construction sector (accounts for 6.5% of GDP) is expected to peak sometime this year as residential investments slowed. A report released by Building and Construction in NZ 2017-18 noted that the longest and strongest construction sector growth phase for NZ will peak soon but activity levels will remain high for some time. We also noted that new residential building consents fell 7.6% m/m in Apr and construction sector saw its first contraction (-1% q/q) in 1Q for the first time in 6 quarters. 1Q inflation breakdown also showed that though construction costs rose by 6.7% in the year to Mar-2017, the quarterly rate of construction cost inflation moderated over late-2016 and early-2017 due to slower growth in residential investment. Should residential investment continue to moderate, the inflation pressure contributed by construction sector could pose smaller risk.

- **Monetary Policy Forecast:** There is no meeting scheduled for Jul. The next one is scheduled on 10th Aug. We expect RBNZ to keep OCR on hold at record low of 1.75% at the upcoming meeting. Accompanying monetary policy statement is likely to remain "neutral" and should

[1] Vehbi, Tugrul (2016), 'The macroeconomic consequences of the age composition of immigration', Reserve Bank of New Zealand Analytical Note, AN2016/03

[2] Armstrong, Jed and Chris McDonald (2016), 'Why the drivers of immigration matter for the labour market', Reserve Bank of New Zealand Analytical Note, AN2016/02.

re-emphasize the need for weaker exchange rate to achieve more balanced growth. With growth still robust, we believe there is room for RBNZ to raise rates earlier than their own forecast – Mar 2020. We believe the RBNZ should be one of the next major central banks to raise rates, possibly as early as end-2017 as inflation is already showing further signs of uptick owing to higher commodity prices, construction-related cost pressures and strength of the domestic economy.

- At the last RBNZ meeting (22 Jun), RBNZ kept OCR on hold at record low of 1.75%. Accompanying statement acknowledged the lower economic growth in 1Q but maintained its positive assessment of the outlook, supported by accommodative monetary policy, strong population growth, and high terms of trade. Budget 2017 is also expected to support growth outlook. Statement also reiterated that the jump in inflation was due to higher petrol and food prices and the effects are likely to be temporary and re-emphasized the need for lower NZD to rebalance growth outlook towards the tradables sector. While RBNZ removed the wordings – 5% decline in Twi since Feb is encouraging, it also explained that the recent 3% increase in TWI was due to higher export prices.

- **Latest Fiscal and External Balance Outlook:** Government finances continue to perform well above expectations with OBEGAL showing a surplus of $2.53bn (vs. forecast surplus of $1bn) for the 10-months to Apr 2017. This was due to higher than forecasted corporate tax revenue. The Treasury this variance to reverse in May's accounts.

- In NZ budget (25 May), surplus is forecasted to rise to NZ$7.2bn by 2021, from forecasted $1.6bn (Jun-2017). The government plans to raise tax thresholds, increase accommodation payments and adjust family tax credits. Though the package will cost $6.5bn over 4 years and is expected to eat into budget surpluses, the package is expected to boost spending. The package will result in a modest increase in inflationary pressure and earlier monetary tightening. (Treasury forecasts short term interest rate will rise from 3Q 2018). Net debt is projected to decline to 19.3% of GDP by 2021 from 23.2% this year. A target of reducing debt to 10-15% of GDP by 2025 has also been set.

- 1Q current account deficit widened to $2.8bn (vs. deficit of $1.7bn in 4Q 2016). For the year ending Mar-2017, the current account deficit widened to 3.1% of GDP (vs. 2.7% of GDP). The deterioration was due to record high imports (good deficit widened to levels not seen since 2Q 2008 and came as a surprise as consensus was expecting a surplus of $1bn.

- **Key domestic events and issues to watch:** Jun food prices (13 Jul); Jun Mfg PMI (14 Jul); 2Q CPI (18 Jul); Jun trade (26 Jul). RBNZ meeting (11 Aug). GDT auctions on 4 and 18 Jul.

- **Technical Outlook:** NZD traded higher for the month of Jun. High was seen at 0.7344 (27 Jun) before the drift lower as we write. Last seen at 0.7290 levels. We observed a bearish divergence on the daily chart and expect some mild correction in coming days. Support at 0.7220 (23.6% fibo). Bias remains to buy on dips. Bullish momentum on weekly chart remains intact. Next resistance at 0.7344 (previous high) before 0.7490 (2016 high).

JPY: Monetary Policy Divergence Back In Focus

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDJPY	115 (118)	117 (120)	117 (120)	119 (--)

Previous forecasts in parenthesis

- **Motivation for the FX View:** In the first five months of the year, the JPY had been one of the best performers against the USD among the Asian FX we cover. The JPY has risen by 5.6% since the beginning of the year to end-May, just lagging behind the KRW and TWD. JPY's moves higher have since stalled and in fact has reversed course, falling 1.5% against the USD so far in Jun. The Fed's 25bp rate hike in Jun and expectations of Fed balance sheet reduction at the end of 2017 had lifted UST yields. The widening yield differentials between the UST and the JGB has provided the USDJPY with a leg up in Jun. But more recently, the increased probability of tightening biases by the ECB, BOE and BOC has lifted long-EUR, -GBP and -CAD bets resulting in cross-selling of the JPY, supporting the USDJPY above the 112-levels at the point of writing.

- This upmove so far has come in short of what we had anticipated for the USDJPY. We had expected a more aggressive climb in the USDJPY by 2Q 2017 as we had penciled in tax reforms and fiscal spending in the US (Trump reflation trade) by 2H 2017. However, these now look unlikely for now given the legislative agenda in the US. This fading expectation of a fiscal boost and tax reforms weighs on UST yields and the USD. But this does not mean the end to the US fiscal boost as we now expect this to be pushed back to 2H 2018. Consequently, we now expect the USDJPY's trajectory for the rest of the year to be slightly more moderate, tracking the moderation in USD strength. We now expect the USDJPY to end 2017 and end-2H 2018 at 117 and 119 respectively instead of 120 previously.

- Supporting the USDJPY upward trajectory is the monetary policy divergence between Japan and its G7 peers. Unlike the BOJ, the Fed remains on a tightening bias and is on track to hike its short-term policy rate at least once more this year in Sep. At the same time, the Fed is also on track to begin its balance sheet reduction by the end of 2017. These should help to support UST yields and is likely to widen the yield differentials between the UST and JGB. Meanwhile, the more hawkish tone taken by ECB President Draghi, BOE Governor Carney and BOC Governor Poloz recently, signaled possible normalization of monetary policy in the EU, UK and Canada. This in turn should see more long-EUR, -GBP and -CAD positions and cross-selling of the JPY. With Japan still on an easing bias in contrast to its

G7 peers, the spotlight is now on the JPY as the funding currency of choice, and should put further downside pressure on the JPY.

- Market indicators also appear to support our view of a more moderate USDJPY trajectory in the next three-six months. Recent CFTC data showed that speculators remained positioned for JPY weakness ahead. The number of short-JPY contracts was at 89,457 contracts as of the week of 20 Jun, while long-JPY contracts were at 39,498. This resulted in a net positioning of 49,959 short-JPY contracts as of the week of 20 Jun, off its peak of net 86,764 short-JPY contracts as of the week of 3 Jan this year. We think that there could be room for even more net short-JPY bets ahead, especially with a re-pricing of Fed tightening bias. This could lift UST yields higher with JGB at least holding steady around current levels, leading to further increases in net short-JPY bets. Such bets should provide the USDJPY with another leg up in 2017.

- Underpinning our expectations for the USDJPY's upwards trajectory, albeit at a more gradual pace, is the central bank's ultra-loose monetary policy, which remains intact. This has been constantly reiterated by BOJ governor Kuroda and more recently in his recent speech in Tokyo where he pointed out that the BOJ remained a long way from the 2% target, making powerful easing still appropriate. This theme was also emphasised by BOJ Deputy Governor Iwata in his speech in Aomori. He had commented that it was not time to reduce the level of accommodation. In addition, the lack of any concrete action plans by the BOJ suggests that the ultra-loose monetary policy is likely to continue into the foreseeable future. This then should continue to put downward pressure on the JPY.

- Opposition to continuing the easing bias within the BOJ should ease with the make-over of the BOJ Monetary Policy Board in Jul. New board members, namely Hitoshi Suzuki - banker with commercial banking and financial markets expertise in Japan and abroad - and Goshi Kataoka - an economist viewed as a reflationist - will replace Takahide Kiuchi and Takehiro Sato when their term ends on 23 Jul. The addition of Suzuki and Kataoka to the board means that there will be no known hawks on the board. This should ensure that BOJ Governor Kuroda has a freer hand to pursue policies that will ensure that the 2% inflation target is achieved.

- Additional easing measures by the BOJ is unlikely for now but such moves cannot be ruled out completely. The BOJ is expected to maintain the status quo with its Quantitative and Qualitative Easing (QQE) with Yield Curve Control. But should inflation fail to gain traction going into 2018, we cannot discount the BOJ unleashing even more easing measures to lift inflation towards the BOJ's 2% target. These easing measures could include cutting interest rate further to -0.3% (from -0.1% currently) and increasing asset purchases of ETFs and J-REITs and other instruments to JPY10tn and JPY6tn.

- Just as important, global risk sentiments have improved and this should refocus attention back to earnings of Japanese firms and their stocks, and hence the Japanese stock markets. Further foreign inflows into the equity markets should be positive for the USDJPY given the strong positive correlation between the Nikkei 225 Index and the

USDJPY. This is because foreign investors usually hedge their equity purchases against further JPY depreciation by short-selling the JPY. Thus, once global risk aversion fades and with volatility at lows, we can expect even more inflows into Japanese equities and hence more upside to the USDJPY. That said, intermittent strength in the JPY due to global risks aversion is to be expected, though these should eventually subside as well and should not stem the depreciating tide of the JPY against the USD.

- Recent flows data showed foreign investors purchasing JPY0.25tn in equities so far in 2017 (up to mid-Jun). This was an improvement over the JPY5.67tn sold off by foreign funds for the whole of 2016. The inflows of foreign funds into Japanese equities have put the Nikkei 225 just a tad off the 2017 high of 20,230 seen on 20 Jun and within striking distance of the multi-year high of 20868 (24 Jun 2015). Further inflows into the Nikkei should be supportive of the USDJPY ahead.

- Given that we no longer expect such a strong USD move for the rest of the year and re-emergence of the monetary policy theme, we have tweaked our USDJPY forecast accordingly. We now expect USDJPY to climb more mildly to 115 (vs. 118 previously) by end-3Q before ending 2017 at 117 (from 120 previously). The climb higher, albeit less aggressively, should continue in 2018 with the pair ending 1Q 2018 and 2Q 2018 at 117 and 119 respectively.

- **Growth and Inflation Outlook:** All the hoopla over the longest streak of growth since 2006 was deflated by the final GDP print for 1Q 2017. Real GDP rose by just 1.0% (4Q16: 1.4%) annualized in 1Q17 compared to preliminary estimates of 2.2% and consensus 2.4%. Growth was dragged down by private inventories, which subtracted 0.1%-point from GDP vs. an addition of 0.1% in the preliminary estimates. Nevertheless, high frequency data released so far suggests that 2Q is off to a good start. Industrial production rose by 4.3% y/y in Apr, stronger than the 3.5% in Mar Feb, while core machinery orders rebounded by 2.0% y/y after declining by 11.9% in Mar. On the external front, export demand remained healthy with growth almost doubling to 14.9% y/y in May from Apr's 7.5% y/y while imports increased by 17.8% y/y from 15.1% in Apr – still pointing to healthy domestic demand. The setback in 1Q aside, the data still points to a healthy pick-up in growth in 2017 and is reflected in the BOJ's projection for 1.6% and 1.3% real GDP in FY2017 and 2018 respectively.

- Headline inflation rose at the same pace as in Apr by +0.4% in May. Core inflation (headline inflation less fresh food) edge higher by 0.4% y/y as expected from 0.3% in Apr, supported by firmer global oil prices. The BOJ preferred gauge of inflation - "core-core" inflation, which is headline inflation less fresh food and energy prices – was stable at 0.0% in May. The CPI print suggests that inflation pressures remain subdued and still a long ways off the official 2% target, underscoring the lack of inflationary pressures despite modest growth recovery. In addition, the lack of significant wage growth (with growth in base wages, i.e. excluding OT and bonuses, capped below 0.5% for the past 12 months) is weighing on inflationary expectations.

The rise in unemployment rate to 3.1% in May should also keep wage growth in check ahead. The lack of inflationary traction means that it would be necessary to continue with the ultra-loose monetary policy "to turn the deflationary mindset" according to BOJ governor Kuroda. The BOJ projects core CPI to come in at 1.4%, 1.7% and 1.9% in FY2017, FY2018 and FY2019 respectively, while the 2% inflation target is expected to be achieved only around FY2018 (i.e. Apr 2018-Mar 2019).

- **Monetary Policy Forecast:** There is little doubt for now that the BOJ will abandon its ultra-loose monetary policy anytime soon. In his post-MPC comments, BOJ governor Kuroda said that it was "not proper to talk about concrete stimulations as it could lead to confusion" in the market when asked about the BOJ's exit strategy. In his recent speech in Tokyo, Kuroda pointed out that the BOJ remained a long way away from the 2% target and it would be appropriate for the BOJ to continue its powerful easing. This view was also reiterated by BOJ Deputy Governor Iwata in his speech in Aomori. He had commented that it was not time to reduce the level of accommodation.

- Further support for continuation of the ultra-loose monetary policy will come with the make-over of the BOJ Monetary Policy Board in Jul. Hitoshi Suzuki – banker with commercial banking and financial markets expertise in Japan and abroad – and Goshi Kataoka – an economist viewed as a reflationist – will join the board to replace Takahide Kiuchi and Takehiro Sato when latter terms end on 23 Jul. With the addition of Suzuki and Kataoka, there will be no known hawks on the board. This should ensure that BOJ Governor Kuroda has a freer hand to pursue policies that will ensure that the 2% inflation target is achieved.

- Additional easing measures by the BOJ is unlikely for now but such moves cannot be ruled out completely. The BOJ is expected to maintain the status quo with its Quantitative and Qualitative Easing (QQE) with Yield Curve Control. But should inflation fail to gain traction going into 2018, we cannot discount the BOJ unleashing even more easing measures to lift inflation towards the BOJ's 2% target. These easing measures could include cutting interest rate further to -0.3% (from -0.1% currently) and increasing asset purchases of ETFs and J-REITs and other instruments to JPY10tn and JPY6tn.

- **Latest Fiscal and External Balance Outlook:** Ruling LDP lawmaker Shigeru Ishiba – a potential challenger to PM Abe for the LDP leadership in 2018 - added his voice to the growing call that the government remain committed to its goal of achieving a primary balance surplus by FY2020. This call comes in the wake of an annual economic and fiscal plan approved on 9 Jun in which the government emphasized the importance of reducing the government debt-to-GDP ratio, which led to speculation that the government would put off the primary balance target. Such a move would allow PM Abe to delay the unpopular sales tax hike for the third time, though a decision has yet to be made on this.

- After widening to JPY2.91tn in Apr, the current account (CA) surplus narrowed to JPY1.95tn in Mar. This could be attributed to the more moderate increase in the goods and services surplus of JPY0.26tn in

Apr vs. JPY1.06tn in Mar. In addition, the surplus in the primary account also narrowed to JPY1.85tn in Apr from Mar's JPY2.20tn. The financial account surplus moderated in Apr to JPY1.07tn from JPY5.02tn in Mar. The smaller surplus in Apr was due to the more moderate FDI of JPY0.47tn (Mar: JPY2.42tn), portfolio outflows of JPY7.31tn (Mar: + JPY3.51tn and the drop in financial derivatives of -JPY0.45tn (Mar: +JPY0.23tn) that more than offset the rebound in 'other investment' and reserve assets of JPY8.06tn and JPY0.31tn respectively (Mar: -JPY0.76tn and –JPY0.38tn). Consequently, the overall balance of payments (BoP) surplus narrowed to JPY2.14tn in Apr from JPY10.05tn in Mar.

- **Key domestic events and issues to watch:** We also have the Tokyo Metropolitan Assembly election on July 2 that could be a test of PM Abe's popularity. Politics aside, it is a busy month for the BOJ. It will release its Tankan survey results for 2Q on 3 Jul. The monetary policy board will meet 19-20 Jul to decide on monetary policy, where it will also release its outlook report. This will be followed by the Governor Kuroda's press conference. The minutes of the 15-16 BOJ meeting will be released on 25 Jul, and the summary of opinion of the 19-20 Jul meeting on 28 Jul. There is only one BOJ speak in Jul by Deputy Governor Nakaso, speaking in Hiroshima on 26 Jul. On 23 Jul, two new members - Hitoshi Suzuki and Goshi Kataoka - will join the BOJ monetary policy board. JGB auctions in Jul: 10-year (4 Jul), 30-year (6 Jul), 5-year (11 Jul), 1-year (18 Jul) and 20-year (13 Jul).

- **Technical Outlook:** Our call (in last month's FX Monthly) – *biased for the downside in the coming days, possibly towards 110.20 levels (200 DMA) which should serve as a firm support level. Decisive move below that suggest further downside possibly towards 109.60, 108.20. Biased to buy on dips, targeting objective at 112.40* - materialized on both the move going down before buying on that dip towards 112.40. Pair was last seen at 112.70 levels. We think momentum indicators support further upside. Next resistance at 113 (76.4% fibo). A decisive close above that could put the pair on track towards 114.40 (May high). Support at 112.20 (61.8% fibo retracement of May high to Jun low) before 111.60 (50, 100 DMAs, 50% fibo). Bias remains to buy on dips.

CNY: PBOC Muscling In

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDCNY	6.80 (6.83)	6.87 (6.90)	6.85 (--)	6.85 (--)
USDCNH	6.80 (6.83)	6.87 (6.90)	6.85 (--)	6.85 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The absence of action by the PBoC right after the Jun Fed rate hike underscores our conviction that the liquidity management by China's central bank will not be as tight as what we have seen in the past few months as activity indicators stabilize and possibly less fiscal expenditure looking ahead. PBOC even confirmed our suspicion, stating that there will not be any further tightening in the 2H of the year. Combine that with upside risks in the UST yields, we had warned of a real potential for the CH-US 10y yield spread to narrow. **Since 6th of June, the spread of CH-US 10y spread has indeed narrowed from its highs of 150bps to 138bps at last sight. As we have noted that CNY tends to weaken when the CH-US 10y yield spread narrows, market forces should lift the USDCNY higher as the yield differentials are poised to narrow further. Any policy muscles used to boost the CNY at this point could just be delaying the inevitable and we might even see a stronger run-up at the end of the year towards 6.87 by the end of this year, with a chance of even overshooting this level.** Taking into account the EUR and the GBP rally in the past few days and some suspected leaning against the wind activities on 27th Jun, more support is likely for the CNY, until the 19th Party Congress this Nov. The firmer EUR and GBP tone could also add downward pressure on the USD against RMB and we recalibrate USDCNY towards 6.80 for 3Q.

- **MSCI** has decided to include the A-shares into its Emerging Market Index and MSCI AC World Index on 21 Jun. Actual inclusion of the A-share stocks has increased to 222 from originally proposed 169 with a 2.5% partial inclusion factor – representing 0.37% weighting in the MSCI Emerging Market Index – which will take place at its regular May 2018 Semi-Annual Index Review. MSCI will increase the partial inclusion factor from 2.5% to 5% during its Aug 2018 quarterly index review. The two-step implementation could be merged into a single phase should the daily limits on Stock Connect be removed or significantly expanded before the scheduled inclusion dates. MSCI seems cautiously optimistic on the progress of the market reform but the two-step approach suggests that MSCI is again, swinging the ball back into China's CSRC court on whether they could seek a greater weighting by doing away with the daily stock connect quota. Our HK-based Analyst Willie reckon that the market impact is limited as the 0.37% weighting and eventual 0.73% after the Aug 2018 quarterly review is a small fraction of MSCI Emerging Markets index's market capitalization and trading volumes. The inclusion is still a milestone in China' capital-market development and integration with the rest of the world. MSCI said that China needs to further improve accessibility for foreign investors, relax daily trading limits through the HK exchange links and make additional efforts to curb trading suspensions in order for A-shares to gain weighting.
- **Our monthly Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) showed a significant improvement for China to 4.7 from previous 5.0 (with 1 being the best and 9 being the worst) on the back of stronger scores for GDP, fiscal and PE valuation.
- **Growth and inflation outlook:** The trade balance of China widened slightly to CNY 281.6bn from previous CNY262.3bn as exports continue to remain on a mild uptrend since the start of year. Imports growth however, outstripped that of exports with a pace of 22.1%y/y for May.

That is an indication of strong demand from China. Metal prices also stabilized to some extent. Looking at the breakdown by goods, May imports saw a jump in demand for manufactured goods from just 1.9% to 7.3%. Exports of manufacture goods in the month also quickened to 5.1%y/y from previous 3.8%. Some stabilization in the manufacturing scene is also noted in the latest PMI-mfg numbers, especially for the small and medium enterprises, a contrast to the fall in PMI-mfg for large enterprises. That could mean some stabilization in PPI prints for the next few months.

- PPI continued to slow to 5.5%y/y from previous 6.4%y/y, weighed by softer metal prices. On the other hand, CPI edged higher to 1.5%y/y from previous 0.9%y/y with food deflation slowing from -3.5%y/y previously to -1.6%. With food and fuel inflation rather anchored, price pressure is likely to remain in check for now.
- Retail sales steadied at 10.7%y/y. The breakdown suggests that rural spending has been rising at a faster pace, a sign of better wealth distribution? The "catering" subcomponent has also been registering faster growth since late last year. Urban spending has been steady. Online retail sales of goods, which makes up around 14.5% of total retail sales of consumer goods, has been recording steady growth of 26.5% for the first five months of the year. We look for private consumption to remain somewhat resilient as the manufacturing sector stabilizes, industrial profits rise (especially in the non-overcapacity sectors) and benign price pressures underpin spending power.
- **Monetary Policy Forecast:** For so far this year, PBoC has raised 1-day SLF rates by 55bps, 7-day and 1 month by 20bp, MLF rates by 10bps and 7-day reverse repo by 20bps. When PBOC failed to follow through with a hike after the Fed hiked in Jun, we were more convinced that China is unlikely to see much tightening towards the end of the year. Whilst the government still desires less debt taking, risk taking and more deleveraging, we think liquidity management might not be as tight. The sharp fall in metal prices have also probably slashed loan collateral values, slow credit growth and squeezed the profit margins of those commodity-related producers. That said, May numbers indicate that metal prices have stabilized, along with industrial profits, retail sales. Domestic demand seems pretty stable, strong even. Recall that PBoC had stated in the (Central Economic Work Conference, 4Q Monetary Report) that monetary policy will be "prudent and neutral". The central bank has been tightening in the first quarter and we expect a more neutral theme in the rest of the year, to ensure a more favourable economic backdrop as the 19th National Congress of the Communist Party of China draws close in autumn.
- **Latest Fiscal and External Balance Outlook:** Premier Li Keqiang said at the World Economic Forum in Dalian that China will keep macro policies stable with proactive fiscal policy and prudent monetary policy. Reducing excess capacity is still a focus and China pledges to use more market-oriented measures to lower steel and coal capacity. From the NPC, Finance Minister Xiao Jie announced that budget deficit for the year is retained at -3% of GDP for 2017 though the absolute deficit amount is raised CNY200bn to RMB2.38trn this year. Fiscal expenditure has been rather aggressive in the first four months

of the year, compared to past years. We are less confident that the government can maintain this pace of fiscal spending. Government debt is low at 36.7% of GDP, local government debt ceiling is to be raised by 10%.

- Implementation is to speed up with the third batch of MoF Public-Private-Partnership taking 11 months to start compared to 15 months for the first batch. This could boost private investment with less fiscal commitment from the government.
- Current account surplus widened to U$19bn in 1Q from previous U$11.8bn due to a smaller deficit in services trade and smaller deficit in income outflows. Trade balance saw a narrower trade surplus of U$81.7bn. BOP has been recording outflow via loan, trade credit and currency deposit that amounted to U$116bn in 4Q. Expect this outflow to narrow into 1Q given that China imposed more capital account restrictions for individuals and corporates to remit or invest overseas since the start of the year. FX reserves saw another mild increase in May, likely due to valuation. Capital outflows seem to have eased for now and with PBOC intervening in the currency markets along with an additional countercyclical adjustment factor to stem volatility, that could temper capital outflow. Nonetheless, capital outflow could still worsen from the current situation as CH-US yield spread continues to narrow.
- **Key domestic events and issues to watch:** NBS Mfg PMI due on 30th Jun, Caixin PMI on 3rd Jul, foreign reserves on 7th, trade on the 13th, CPI, PPI on 10th, monetary data on 10-15th. Retail sales, FAI, industrial production on 17th along with **2Q GDP.** Property prices on 18th followed by FX Net settlement on 20th. Industrial profits on 27th.
- **Technical Outlook:** USDCNH made another sharp move lower since 27th Jun, not helped by the firmer EUR and GBP tone. The USDCNY fixing has been on the aggressive side of our estimates and we suspect the central bank has been using the "countercyclical adjustment factor" to boost the CNY. Downside pressure in the dollar could be short-lived could allow the USDCNH and USDCNY to slide towards the lower end of the 6.72-6.82 range that we have been looking at. Prefer to buy on dips for this pair towards our eventual target of 6.87 towards the end of the year.

KRW: More Weakness Ahead

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDKRW	1150 (--)	1160 (--)	1170 (--)	1180 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** We still expect USDKRW to trade higher supported by the widening yield differentials between UST-KTB (in favor of the USD) and via risk sentiment channel as gradual but eventual withdrawal of monetary stimulus could weigh on asset prices. In particular KOSPI has rallied 17.5% YTD (the biggest gainer in Asia) and could be poised for sharp correction should risk sentiment deteriorates. That said we are not expecting a blow-up to the upside as Korean macro-fundamentals are showing further signs of recovery. For the month of Jul, we see USDKRW trading a higher range of 1125 – 1165 (vs. 1115 – 1145 in Jun).

- Recent FoMC meeting (15 Jun) and Fed speaks suggest that Fed is determined to normalise monetary policy. Fed is still looking for another 25bps hike and to start balance sheet unwinding this year. Contrast this against BoK which is expected to keep monetary policy accommodative for now should see monetary policy divergence growing and re-exert a widening of UST-KTB yields. Fed fund policy rate has now caught up with BOK at 1.25% while 2Y yield differentials between UST and KTB has narrowed from -42bps to about -25 bps and eventual market re-positioning for higher UST yield should see UST-KTB widening in favor of UST.

- We do not see a strong case for BoK to rush into raising rate at the upcoming meeting despite the rise in Korea's inflation towards BoK's target level of 2% level and BoK Governor Lee's hint (13 Jun) at the possibility of raising the benchmark rate over time. Inflationary pressures from the demand side are not expected to be high and the government is also in process of hoping to push through supplementary budget to create jobs and we believe BoK is likely to coordinate with the government in keeping monetary conditions loose during this period.

- We **maintain our USDKRW forecast over the forecast horizon and keep the upward trajectory in USDKRW** into the turn of the year as we expect markets to reprice Fed's monetary tightening and Trump's plan on tax reforms and fiscal spending take shape towards end-2017.

- **Downside Risks to Our Outlook:** USDKRW could face renewed downside pressure (1) if Fed renegades in its pace of monetary tightening while Asia economic rebound continues, with KOSPI surging to another fresh highs. We would expect this situation to resemble one that is of low volatility and a return to FX play favoring EM currencies including KRW; BoK could move to tighten if Korea inflation jumped above 2% for the next few months.

- **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 held steady at 6.9.

- **Growth and Inflation Outlook: 1Q GDP growth was revised upwards** (+1.1% q/q vs. previous estimate of +0.9%). This was the fastest quarterly growth in 6 quarters and was due to construction, facility investment and exports in the private sector. Recovery in private consumption (+0.4% q/q in 1Q) continues to pale in comparison to previous year but rising consumer sentiment to more than 6-year high and planned KRW10tn supplementary budget to target job creation and support growth (if managed to pass through) should help domestic demand recover soon. We expect BoK to announce upward revision to its 2017 growth forecast from 2.6% in its Jul meeting.

- The incumbent government headed by President Moon has submitted the KRW10.2tn supplementary budget proposal to the Assembly (7 Jun) for approval. The plan is focused on job creation (about 110,000 jobs including 71,000 jobs in the public sector), to support growth. This was part of Moon's election campaign and is in response to rising unemployment. Unemployed persons stood at near recent high of 1.003 million (a small decrease from 1.17 million in Apr). Budget will be financed by accumulated tax revenue without issuing national bonds. It is now subjected to a vote and should be announced soon. Initial talks suggest that the opposition viewed the budget plan negatively. A majority vote in the 299-seat Assembly is required for the supplementary budget to be passed but the ruling party only holds 120 seats.

- **Headline inflation for May rose towards BoK's target of 2%. The rise** was due to food and non-alcoholic as well as petrol prices. Core inflation firmed to 1.5% (vs. 1.3% in Apr). The BoK expects CPI inflation to fluctuate around the 2% level for the year as a whole and core CPI to show a level in the mid to upper 1% range.

- **Monetary Policy Forecast**: We acknowledged BoK Governor Lee's hint (13 Jun) at the possibility of raising the benchmark rate over time; he said he would consider adjusting the extent of monetary easing if economic conditions showed clear signs of improvement. But we expect BoK to hold its horses and keep monetary policy accommodative, with policy rate on hold at record low of 1.25% at the upcoming meeting (13 Jul).

- True that inflation has been rising and is expected to fluctuate around the 2% level (BoK's target range) and headline growth firmed with consumer sentiment rising to 6-year high, the domestic demand side of the equation is still missing. Private consumption remains sluggish and supplementary budget has yet to be approved. Inflationary pressures from the demand side are not expected to be high for now. We do not see any urgency to rush into premature easing as BoK is likely to co-ordinate with government as the latter strives to create jobs through fiscal measures. That said we do not expect BoK to keep rate low for prolonged period and we think a potential rate hike is possible towards 4Q-2017 (at the earliest).

- **Latest Fiscal and External Balance Outlook:** Current account surplus narrowed to US4bn in Apr (vs. US$5.75bn in Apr) due to dividend payment to foreign investors. Increase in foreigners' purchase of Korean equities and improvement in companies' profitability led to the rise in dividend pay-out.

- Korea's sovereign debt is expected to increase to KRW682.4tn by end-2017, from KRW641tn. Government debt now stands at 44.8% of GDP. The rising debt has to do with tax cuts and increasing welfare spending made during former President Lee's era. The National Assembly Budget Office estimates government debt will rise to KRW800tn in 3 years' time.

- **Key domestic events and issues to watch:** S. Korea releases Jun trade data (1 Jul); PMI (3 Jul); CPI (4 Jul); unemployment rate (12

Jul); first-20 days of exports data (21 Jul); 2Q prelim GDP (27 Jul) and Jun Industrial Production (28 Jul). BoK meets on 13 Jul.

- **Technical Outlook:** Our bias to buy on dips continues to work well. And we continue to hold to the bias looking for higher levels into July. Pair was last seen at 1141. Weekly, daily momentum indicators continue to suggest a bullish bias. Though stochastics show signs of turning lower from overbought conditions, we see retracement lower to be shallow towards 1128 (50 DMA), 1120 levels. Chart pattern suggests a potential push towards 1155-1160 levels should key resistance at 1145 (200 DMA) – 1149 (38.2% fibo retracement of 2017 high to low) breaks down.

SGD: Compression Of Yield Differentials To Still Weigh But Healthy Fundamentals To Limit Downside

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDSGD	1.3900 (1.4200)	1.3800 (1.3950)	1.3950 (--)	1.4050 (--)

Previous forecasts in parenthesis

- **Motivation for the FX View:** The expected SGD weakness in May and Jun did not materialize. Instead of climbing towards the 1.41-levels by end-2Q, the USDSGD slipped lower below the 1.38-levels at the point of writing. The strength in the SGD could be attributed to the lack of progress on tax reforms and infrastructure spending in the US (i.e. Trump reflation trade) that has slowed USD upward trajectory. The fading reflation trade suggests that UST yields are unlikely to rise as steeply as previously anticipated and should weigh on the USD. In addition, the increased probability of tightening biases by the ECB, BOE and BOC has lifted long-EUR, -GBP and -CAD bets and weighed on the USD, providing the USDSGD with fresh impetus for another leg lower. This together with the ongoing synchronized recovery in exports in the region, possible monetary policy convergence with the US, and the low volatility environment as reflected in the VIX index, should spur flows into riskier assets, including those in Singapore, and are supportive of the SGD. As a result, we have tweaked our USDSGD forecast to take into account the more moderate strength of the USD. We now expect the USDSGD to end the year at 1.3800 instead of 1.3950 previously.

- Our underlying assumption remains for the USDSGD to rebound in the next three months, underpinned by a rise in UST yields. The rise in UST yields is likely to be underpinned by steady US economic growth, the ongoing normalization of US rates with a hike possibly in Jun and then another in 2H, expectation of Fed's unwinding of its QE, and possible EUR pullback amid disappointment with ECB policy. We also cannot discount the possibility that the global reflation trade could re-emerge that could lift UST yields. The rise in UST yields is likely to have a significant impact on the USDSGD, given that the USDSGD is one of the most sensitive currency pair to moves in 10Y UST yields. This rise in UST yields is likely to narrow the yield differentials between the UST and SGS (assuming no change in SGS yields) and result in outflow of funds back to the US, lifting USD and hence the USDSGD higher. This should keep the USDSGD elevated in 2017.

- Apart from the more moderate USD trajectory due to fading Trump reflation trades, the healthy macroeconomic fundamentals of the economy led by the synchronized recovery in exports in the region also plays a part in dampening aggressive upside in the USDSGD for the rest of the year. In addition, the SGD should find support from the government's mildly expansionary fiscal policy, which together with still accommodative monetary policy, its triple-A status and persistent balance of payments surpluses, should supportive of the SGD and limit upside to the USDSGD. With the SGD supported amid moderate USD strength, an even sharper climb in the USDSGD is no longer our base case for 2017.

- In an environment of low (equity, FX and government bond) volatility and fading global reflation trades, long USDSGD positions continue to be unwound. In addition, elevated real bond yields for Singapore (currently at 0.68% as at end-May) vis-à-vis US real bond yields (at 0.33%) should be supportive of Singapore debt instruments and equities, providing additional support for the SGD. Data on foreign ownership of Singapore equities and government debt is lacking but recent yield movements as well as gains in the STI suggest healthy demand for Singapore assets that should also include foreign interest. Yields across most tenors (except for 6M and 1Y) were mostly lower by 1.85-18.15bp, while the STI has climbed by 0.3% so far in Jun.

- A sharper move by the SGD is likely to come in 4Q when the MAS holds its monetary policy meeting in Oct. Our house view remains for a possible adjustment to the current 'neutral' policy stance in Oct to one of a 'mild appreciation bias'. This is underpinned on our expectations of accelerating core inflation and economic momentum. This tightening bias of the MAS would be supportive of the SGD and allow the USDSGD to slide lower towards the 1.38-levels by the end of the year. Should MAS maintain the status quo at its Oct meeting, we could see the USDSGD rebound revisit the 1.40-levels by year-end. We will continue to monitor incoming data over the next few months for evidence of rising inflationary pressures that would be supportive of a policy tightening in Oct.

- To take into account the delay in global reflation trades due to the lack of progress on the US front and tightening monetary bias in some of the other G7 economies, we have revised our USDSGD forecast lower. We now expect the currency pair to end-3Q and end-2017 at 1.39 and 1.38 respectively (previous: 1.4200 and 1.3950). Thereafter, expectations of US reflation trades in 2H 2018 should spur USD strength and lift the USDSGD higher to 1.3950 and 1.4050 by end-1Q 2018 and -2Q 2018 respectively.

- **Singapore's monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) has improved to 4.4

from 4.7. The improvement was due to lower GDP and current account risks. This should be supportive of the intrinsic value of the SGD. Our model shows that the SGD NEER was last seen 0.27% above the mid-point implied at 1.3819. Upper bound is implied at 1.3544 while lower bound is now at 1.4095.

- **Growth and Inflation Outlook:** High frequency data appears to point to a moderation in real GDP growth in 2Q 2017 after the economy expanded by 2.7% for 1Q. Manufacturing shows signs of moderating with industrial production (IPI) rising by a more moderate 5.0% y/y in May vs. 6.7% in Apr. IPI was dampened by the continued weakness in pharmaceuticals that partially mitigate the gains in electronics. Electronics production sustained its double-digit growth, rising by 35.1% y/y in May. This marked the 12 consecutive month that electronics output has expanded at a double-digit pace. PMI data for electronics (May: 52.4 vs. Apr: 51.6) suggests that electronics still has legs to run further. Moreover, the rebound in in non-oil retained imports (by 14.3% y/y in May from -0.3% in Apr) suggests that final demand remain healthy. Though services underperformed in 1Q, our economic team expects services growth to firm in 2Q, underpinned by stronger financial, business and wholesale services growth. This improvement in services should lend support to stronger growth in 2Q and eventually for the full year. Our economic team expects real GDP to come in at 2.8% y/y in 2Q, a slight improvement from the 2.7% in 1Q. For the full-year, real GDP is projected at 3.0% for 2017. This is broadly in line with the MTI's upbeat outlook for the year where it expects growth to come in "higher than 2.0%", barring downside risks.

- Headline inflation rose 1.4% y/y (Apr: +0.4%) in May due to base effects relating to service & conservancy charges rebates disbursement. Core inflation (headline inflation excluding accommodation and private transport costs) though softened mildly to 1.6% y/y (Apr: 1.7%) on lower services inflation. Despite this setback, our economic team continues to expect a gradual pick-up in inflation in the remainder of the year, supported by the cyclical growth recovery, as well as the planned administrative price increase (such as the hike in service & conservancy charges and water prices in Jul). With inflation risk to the upside ahead, our economic team maintains their headline inflation and core inflation forecast at 1.2% (MAS forecast 0.5%-1.5%) and 1.6% (MAS forecast 1%-2%) respectively in 2017.

- **Monetary Policy Forecast:** The MAS has maintained its 'neutral policy' stance since Apr 2016. At its Apr meeting, the slope of the SGD NEER policy was kept at zero percent and there were no changes to the width of the policy band or the level at which it is centered. The forward guidance that the neutral policy stance is appropriated for "an extended period" remained in place, against expectations of some participants in the market that it would be removed. Its removal would have signaled a shift towards a tightening bias by the de-facto central bank. Our house view remains for a possible adjustment in the MAS policy stance at the Oct meeting. We expect the MAS will likely normalize and for a shift to a "slight appreciation bias", underpinned by upside inflation risk due to the uptick in administrative prices (water, service and conservancy charges) and a cyclical growth recovery.

- Support for a "mild appreciation bias" also comes from our estimates using the Taylor Rule, which showed that a shift in policy stance is appropriate. Our estimates show that the SGD NEER is expected to strengthen ahead and suggests that the current policy parameters could be adjusted at the next policy meeting in Oct. This should temper inflationary pressures that could arise in the next six-to-nine months amid a synchronized recovery in exports in the region and possibility of stronger global growth led by the US.

- The USDSGD traded to a new low for 2017 at 1.3709 (on 14 Jun) – a level not seen since Oct 2016 – amid a pullback in the USD. Pair has since rebounded back above the 1.38-handle at the point of writing. This oscillation in the USDSGD so far this year has seen the 3-month SOR (3MSOR) coming off from 1.0152% on 4 Jan to hit a low for the year at 0.6407% on 22 Jun. 3M SOR has since bounced higher to hover around 0.6867% as at 27 Jun. Similarly, the slide in the 3-month SIBOR (3MSIBOR) has been more gradual with the rate falling from 0.9689% at the start of the year to hit a low of 0.9391% on 24 Feb before climbing back towards the 1.0% at 0.9956% currently. The more modest rise in rates suggests that the rise in mortgage rates is unlikely to be significant for now. Deposit rates (for 12-month fixed) have not risen since end-Jan but has slipped lower to 0.33%. 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.

- Upward pressure on domestic rates remains with only one more Fed rate hike expected for the remainder of 2017, though Fed balance sheet reduction could similarly put upside pressure on rates. US 3MLIBOR continues on its upward trajectory and is currently hovering around 1.20% at the point of writing, a new high for 2017. Ample liquidity has so far kept domestic rates from tracking the US 3MLIBOR higher though. With US rate hike trajectory still on a slow grind higher, domestic rates should also rise at a more gradual pace. We continue to expect the 3MSIBOR and 3MSOR to end-3Q 2017 at 1.37% and 1.15% respectively. For the full-year, we expect the rates to end 2017 at 1.61% and 1.39% respectively.

- **Latest Fiscal and External Balance Outlook:** Operating revenues rose moderately to SGD69.45bn in Mar from SGD68.67bn in Feb, while total expenditure rose to SGD75.07bn in Mar from Feb's SGD71.39bn. This led to a primary deficit of SGD5.62bn in Mar, up from -SGD2.72bn in Feb. Nevertheless, with special transfers, top-ups and net investment income, the overall budget was in a surplus of SGD1.91bn in Mar (Feb: SGD5.18bn).

- The current account surplus widened to SGD19.40bn in 1Q 2017 from SGD18.13bn in 4Q 2016. The larger surplus was attributable to the more moderate deficits in the primary income (1Q: -SGD1.68bn vs. 4Q: -SGD3.74bn) and secondary income (1Q: -SGD3.63bn vs. 4Q: -SGD3.81bn). The financial and capital deficit however narrowed sharply to SGD3.28bn in 1Q17 from 4Q's SGD22.73bn on the back of a sharp drop in portfolio investment outflows of SGD2.90bn (4Q:

SGD13.96bn) and an inflow to financial derivative of SGD8.27bn (4Q: +SGD3.37bn). As a result of the smaller deficit in the financial and capital account, the overall balance of payments (BoP) rebounded back into surplus of SGD16.61bn from 4Q's deficit of SGD3.93bn.

- **Key domestic events and issues to watch:** Advanced GDP will be released sometime 10-14 Jul.

- **Technical Outlook:** USDSGD traded a range of 1.3709 – 1.3915 this month. Pair was last seen at 1.3805 levels. Daily momentum and stochastics indicators suggest some downside pressure but weekly MACD suggests the risk of bullish divergence. We are biased to buy on dips, for a move back up towards 1.3870 (38.2% fibo retracement of May high to Jun low), 1.3920 (50% fibo). Support at 1.3709 (previous low).

MYR: Remaining Resilient in a Tight Range

Forecast	3Q 2017	4Q 2017	2Q 2018	2Q 2018
USDMYR	4.2500 (--)	4.3000 (--)	4.3000 (4.3500)	4.2500 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** We remain positive on the Ringgit outlook given the recent initiatives from BNM to broaden and deepen the onshore financial markets. We interpret these steps as positive development and expect foreign investors' confidence to gradually return. Thus far foreign investors interest in Malaysian equities and bonds have picked up, with data up until July showing inflows.

- Foreigners remained as net buyers of Malaysian equities i.e. +MYR0.5b up to 21 June 2017, adding to the +MYR10.5b net buying in the first five months of this year on expectations of earnings growth (Maybank KE Equity Research expects KLCI core earnings to pick up to +8.4% in FY2017 and +7.0% in FY2018 after a stagnant 2014-2016). Meanwhile, net foreign flows in the Malaysian bond market for Jun 2017 will only be available by the end of first week of July 2017. Foreigners were net buyers of bonds for the second straight month in May 2017, totaling +MYR10.1b (Apr 2017: +MYR6.8b), reversing the sustained net selling between Nov 2016 and Mar 2017. There is no data on net flow of foreign direct investment of (FDI) for the current quarter, but it registered a larger net inflow last quarter (1Q 2017: +USD1.9b; 4Q 2016: +USD0.2b) which help to mitigate the net outflows of portfolio investment in the first three months of the year, in turn allowing the external reserves to rise. The continued increase in external reserves in current quarter suggests FDI net flows remain positive.

- Given improved investors' sentiment, well-managed expectation for Fed rate hike given pricing in of forward guidance this year, less dependence on oil for revenue, and MYR being fundamentally and historically undervalued, we see scope for Ringgit to play catch up with regional peers and extend its gains towards 4.25 levels (vs the USD) for 3Q, before some strength in the USD potentially supporting the pair at around 4.30. We are maintaining our USDMYR forecast across the 2017 forecast horizon.

- We reiterate our **long-standing bias that the Ringgit remains fundamentally undervalued.** Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.70 levels. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We believe stability is gradually returning to Ringgit as political/ contingent liability risk subsides, fiscal consolidation gains traction, oil prices continue to stabilize and uncertainty subsides. Solid underlying fundamentals and policies, backed by domestic demand, re-calibrated supportive budget (on a lower oil price assumption suggests flexibility in the fiscal space), relative stability in oil prices though some downside pressure exists, relative attractive yields in the MGS, stabilizing FX reserves to retained imports & short-term debt, accommodative monetary conditions (to support businesses) remain intact and should provide an anchor for MYR stability once short-term noises subside. We believe USDMYR range of 4.20-4.40 is likely to remain relatively sustained for 2017.

- **Positive Development to Deepen Onshore Financial Markets**. According to BNM press release (13 Apr), the Financial Markets Committee (FMC) announced a number of initiatives targeted to promote (1) a fair and effective market, (2) improve bond market liquidity; (3) ease hedging activities and; (4) enhance transparency and market information. All the initiatives under (1) to (3) will take effect on 2 May 2017 (Tue) while enhancement to financial market infrastructure will be implemented on a gradual basis and is expected to be completed over a 12 – 18 month period. In particular on points 2 and 3, the regulated short-selling of securities in wholesale money market will be liberalized to allow all residents to participate in short selling activities. This is to facilitate a more effective avenue for the hedging of interest rate risk exposure as well as to generate more trading activities and liquidity in the secondary government bond market. Eligible securities for short-selling transactions will also be expanded to include Malaysian Government Investment Issue (MGII) with an outstanding nominal amount of at least MYR2bn, on top of Malaysian Government Securities (MGS). The aim is to elevate liquidity in the MGII issue and narrow the pricing gap between MGS and MGII. A consultation paper will be issued for market feedback (by 28 Apr) on this proposed inclusion of MGII for short-selling activities. Registered non-bank entities (including institutional investors, companies) will be allowed to hedge up to 100% of their underlying assets and to manage an additional 25% of FX exposures. This allows registered investors to fully hedge and actively manage their FX exposures including unwinding of hedging positions.

- Total gross external reserves rose USD0.7b to this year’s new high of USD98.7b in mid-June 2017 (end-May 2017: USD98.0b) underpinned by the USD0.7b rise in foreign currency reserves component to USD92.3b (end-May 2017: USD91.6b). Total gross external reserves level has also risen to surpass last year's high of USD98.3b level in mid-Nov 2016.

- **Growth and Inflation Outlook:** Index of leading economic indicators rose +1.4% YoY in Apr 2017 (Mar 2017: +1.7% YoY), suggesting the real GDP growth momentum is intact in 2Q 2017 following the better-than-expected +5.6% YoY expansion in 1Q 2017. Industrial production (IP) growth moderated for a second month in Apr 2017 to +4.2% YoY (Mar 2017: +4.6% YoY) despite the pick up in manufacturing output, which was offset by declines in mining and electricity production.

- Our Economists had last month upgraded the 2017 real GDP growth forecasts to +5.1% from +4.4% previously (2016: +4.2%) factoring in the 1Q 2017 GDP numbers, and reflecting mainly upward revisions in the growth of manufacturing (to +5.0% from +4.5%), services (to +5.8% from +5.6%) and agriculture (to +7.0% from +1.5%) on the supply side, and the growth of consumer spending (to +6.4% from +5.9%), public consumption (to +5.5% from +2.9%), investment (to +6.7% from +3.9%), exports (to +7.8% from +1.3%) and imports (to +9.7% from +1.5%) of goods and services on the demand side.

- The prospect of better than expected pick up in real GDP growth this year after the slowdown in 2015-2016 adds to the list and sense of easing macro pains experienced in the past 2-3 years, which include the expected corporate earnings recovery after 3 years of "no growth" which triggered net foreign buying in the equity market year-to-date; sustained current account surplus; delivery of fiscal consolidation targets; stabilization and strengthening of MYR; as well as the receding "foreign holding risk" in the bond market.

- The wild card is external trade in view of the uncertainties over the US trade policy under President Trump, especially the risk to US-China trade relation. However, under the current expectation of a moderate pick up in global economic growth and firmer commodity prices, we are looking at relative better trade growth in 2017 i.e. higher growth in exports and imports of goods and services.

- We continue to keep a close tab on key high frequency domestic data, namely the monthly economic indicators such as the indices on industrial production and distributive trade, external trade, money and banking statistics, as well as major commodity output and prices. In addition, our focus is also on the economic trends as well as policy and political developments in the major economies i.e. US, Europe (including UK), China, Japan.

- Headline inflation rate in May 2017 eased for the second month in a row to +3.9% YoY (Apr 2017: +4.4% YoY), but core inflation edged up slightly to +2.6% YoY (Apr 2017: +2.5% YoY). Year-to-date headline inflation rate is +4.3% YoY (Jan-May 2016: +2.9% YoY) while core inflation rate is +2.5% YoY (Jan-May 2016: +3.0% YoY). No change in our full-year 2017 inflation rate forecast at 3.5%-4.0% (2016: +2.1%).

- Headline inflation rate eased further to +3.9% YoY in May 2017 (Apr 2017: +4.4% YoY; Maybank-KE: +3.9% YoY; Consensus: +4.1% YoY). The trend in headline inflation continued to be dominated by "Transport" costs, which also decelerated for the second consecutive month (May

2017: +13.1% YoY; Apr 2017: +16.7% YoY). Meanwhile, core inflation rate which exclude volatile food and energy prices as well as price-controlled/pricesubsidised components of the CPI, including fuel prices) edged up to +2.6% YoY (Apr 2017: +2.5% YoY). Compared with Apr 2017, headline inflation declined -0.2 % MoM while core inflation rose +0.3% MoM.

- The current trend in inflation is in line with our view that the +5.1% YoY headline inflation posted in Mar 2017 was the peak and expect headline inflation for the rest of the year to moderate from Apr 2017 onwards, although it will average around or slightly above +4.0% YoY in 1H 2017. This expectation reflects the view that the current "cost-push" headline inflation – largely due to the impact of the earlier surge in crude oil price on the domestic fuel prices which is a key element of the CPI's "Transport" component - will taper as "demand-pull" and "wage-driven" inflationary pressures are contained as suggested by the relatively stable core inflation rate, the sticky unemployment rate of around 3.4%-3.5% since Dec 2015, and the indication of slower growth in salaries and wages so far this year compared with last year (refer to our report "Labour Statistics, Mar 2017: Stable Jobless Rate, Slowing Income Growth", 18 May 2017). Maintain our 2017 and 2018 headline inflation rate forecasts of 3.5%-4.0% (official 2017: 3.0%-4.0%; 2016: +2.1%) and 2.0%-2.5% respectively.

- **Monetary Policy Forecast:** We also maintain our call that the Overnight Policy Rate (OPR) will be kept at 3.00% p.a. as the latest data on inflation is consistent with BNM's view that the surge in headline inflation is temporary and will moderate, while core inflation rate is contained.

- BNM kept the Overnight Policy Rate (OPR) at 3.00% at its MPC meeting on 12 May 2017. The tone of the accompanying Monetary Policy Statement (MPS) remained "neutral". No change in our view of OPR staying at 3.00% this year.

- The tone of the latest Monetary Policy Statement (MPS) is largely unchanged vs the previous MPS issued after the 1-2 Mar 2017 MPC. Essentially, BNM is keeping its monetary policy stance to remain accommodative and supportive of the domestic economy whose growth momentum in 2H 2016 should strengthen in 1Q 2017 and will be sustained for the rest of the year amid the synchronized pick up in global economic activities such as output and trade in both the advanced and the emerging economies that is positive for Malaysia's exports on top of the steady domestic demand driven by continued wage and employment growth as well as the implementation of new and on-going investment projects.

- No change in our view of OPR staying at 3.00% this year. BNM is hinting at a stronger 1Q 2017 growth after the pick up in 2H 2016, in line with our estimate of around +5.0% YoY real GDP growth last quarter (4Q 2015: +4.5% YoY) based on supply side indicators such as the industrial production index, index of services, value of construction works done and palm oil output (see out note on 1Q 2017 Real GDP Preview, 12 May 2017). 1Q 2017 real GDP numbers will be released on 19 May 2017.

- Notwithstanding the potential upside surprise in growth, BNM maintained its view that the surge in headline inflation so far this year (1Q 2017: +4.3%; 2016: +2.1%) is temporary and will moderate in 2H 2017, while core inflation will rise only modestly as the cost-driven inflation is not expected to have a significant impact on the broader price trends given the stable domestic demand conditions.

- Furthermore, BNM still see risks to global and local economy from protectionism, geopolitical developments and uncertain trajectory of global crude oil prices, which could reignite financial market volatility.

- **Latest Fiscal and External Balance Outlook:** Themed "Accelerating Growth, Ensuring Fiscal Prudence, Enhancing Wellbeing of People", Budget 2017 maintains commitment to fiscal discipline and consolidation; supports domestic demand via corporate income tax rate cut, incentives for tourism, SMEs, exports and digital economy, and infrastructure investment; and focuses on the wellbeing of the low-and middle-income groups by addressing the issues of inclusivity, equality, cost of living and affordable housing.

- Budget deficit target for 2017 is set at -3.0% of GDP, sustaining the policy of fiscal consolidation since 2010. This year's aim of -3.1% of GDP is maintained and achievable. Based on monthly data, we estimated budget deficit in Jan-Aug 2016 was -3.9% of GDP as the deficit of -5.6% of GDP in 1H 2016 turned into an estimated surplus of +1.2% of GDP in July-Aug 2016.

- We expect the fiscal deficit to remain flat at 3.1% of GDP, as government spending is likely to pick up (as we enter the election campaign).

- **Key domestic events and issues to watch:** BNM policy decision (13 July); Trade data (7 July); FX reserves (7, 21 July); Industrial Production (12 July); CPI Inflation (19 July).

- **Technical Outlook:** Our call (in last FX Monthly) for USDMYR to rebound towards 4.30 off the back of stretched signs of oversold conditions materialized. USDMYR traded high of 4.3022 levels. Last seen at 4.2940 levels. Bearish momentum on monthly and weekly chart remains intact but in the short term, we still see signs of rebound, possibly towards 4.31 (50 DMA), 4.3240 (38.2% fibo retracement of Apr high to Jun low). But bias remains to sell on rally for a move back towards 4.25 support.

IDR: Slow Grind Lower

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDIDR	13400 (--)	13450 (--)	13500 (--)	13500 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** Though the IDR has been largely stuck in range trades in Jun, we continue to expect the IDR to grind higher in the remainder of 2017, albeit at a gradual pace, as we expect USD strength to moderate on fading reflation trades. A combination of healthy economic fundamentals, low volatility, cyclical growth recovery, fading global growth conditions and relatively easy financial conditions have favoured IDR as a carry currency of choice in Asia and possibly cap upside to the USDIDR for the remainder of the year. Even the credit rating upgrade by S&P to investment grade has favoured IDR carry trade. These continue to be positive for the IDR in the medium term, helping to broaden the appeal of Indonesian assets and capping USDIDR upside. Already, IDR has produced the best volatility-adjusted carry trade returns so far in Jun of 3.7%.

- In the next three-to-six months, the more moderate strength in the USD due to the lack of progress on tax reforms and fiscal spending (reflation trades) by the US should limit downside to the IDR. Fading reflation trade suggests that UST yields are unlikely to rise as steeply as previously anticipated, and this should weigh on the USD. However, we expect USD strength to re-emerge in 2018 as we expect US reflation trade to receive fresh impetus in 2H 2018.

- Nevertheless, we do not expect the more moderate USD strength to translate into a sharp fall in the USDIDR. This is because there is a possibility that official agents may enter into the market to limit downside moves by the USDIDR. Smoothing volatility in the IDR and managing the IDR move higher should ensure that the country's competitiveness is maintained. Already, market whispers have suggested that official agents have been in the market intermittently to curb IDR strength above the 13300 levels so far this year.

- While the USDIDR remained supported above the 13300 levels as described above, narrowing yield differentials in favour of the US could spur some outflows from Indonesian assets. The rise in UST yields should receive impetus from our expectations of at least one more Fed rate hike in Sep and also from the Fed's reduction of its balance sheet at year-end. In addition, expectations of policy normalization in other G7 economies, namely the EU, UK and Canada, could also lift global rates even higher. Higher returns elsewhere then could see a flow reversal from Indonesian assets back to the G7 economies, curbing the attractiveness of the IDR as a carry currency and lift the USDIDR higher.

- We could be getting a foretaste of what is to come. For the second consecutive month, foreign investors have fled Indonesian equities. They sold off nearly USD0.32bn in equities so far in Jun, more than the USD0.05bn sold off for the whole of May. Government debt though remains in favour with foreign investors, driven by the S&P credit upgrade. Nevertheless, sentiments have begun to fade as reflected by their more moderate purchases of government debt. Foreign purchases of government debt have slowed since Mar with IDR8.06tn purchased so far in Jun, down from May's IDR10.33tn. As a result, any further outflows from equities and moderation in government debt purchases could weigh on the IDR for the rest of the year.

- At the same time, any upside to the USDIDR is likely to be a slow grind given the healthy macroeconomic fundamentals so far. Even though growth has underperformed some of its regional peers, real GDP is expected to improve and expand by at least 5% this year. Support for growth will likely come from the 15 reform/stimulus packages introduced so far that should help to cut red tape and liberalize rules that have been a drag on the economy. In addition, government's efforts to rein in the budget deficit by cutting unnecessary expenditure last year and the successful implementation of the tax amnesty program that have increased government revenue have provided more fiscal space to the government in 2017 to embark on its ambitious infrastructure building programme. The government has committed USD400bn for infrastructure building that should not only lift potential growth but the IDR. Accordingly, we continue to expect the USDIDR to end 2017 at 13450 before climbing higher to hover around 13500 in 1H 2018.

- **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Indonesia was unchanged at 5.3. The deterioration in inflation risk was completely offset by the improvement in fiscal risk. This should be supportive of the intrinsic value of the IDR.

- **Growth and Inflation Outlook:** BI expects the economy to expand lower than 5.11% in 2Q, still better than the 5.01% in 1Q, before accelerating further by more than 5.2% in 3Q and 4Q. This more optimistic outlook is likely premised on healthy private consumption spending, stronger investment in the wake of S&P's investment upgrade for Indonesia and further improvement in government spending. Already we are seeing healthier purchases of motor vehicle and motorcycles that is reflective of the improvement in private consumption. Motor vehicle sales were steady at 5.9% and 5.7% y/y in Apr and May respectively, while motorcycle sales rebounded by 5.8% y/y in May from Apr's -12.5%. We have also seen FDI rebound in 1Q 2017, rising USD2.76bn, after contracting by USD7.71bn in 4Q 2016. More importantly, the government is likely to push ahead with its implementation of President Jokowi's USD400bn infrastructure programme that should not only bolster growth in the near term but also potential growth. Externally, the synchronized export recovery in the region should also provide growth with a lift. Exports have expanded at double-digit pace since Nov 2016 and imports since Jan 2016. In May, exports and imports were up by 24.08% and 24.03% y/y respectively. For the full-year, government continues to expect full-year growth to come in at 5.3% in 2017, while BI continues to see growth forecast range is 5.1-5.2% as more reasonable. Our economic team's outlook for the economy is more in line with that of BI at 5.1% for 2017.

- After 12 months at sub-4.0% levels, headline inflation has crept back up above that level for only the second time in May. Headline inflation rose by 4.33% y/y in May, higher than Apr's 4.17%. This acceleration could be attributable to the jump in food prices (largely because of base effects from sugar) by 3.37% y/y from 2.80% in Apr and higher housing and utility costs (up 5.54% y/y in Mar vs. 5.19% in Apr). Core inflation though slipped marginally lower to 3.20% y/y in May vs. 3.28% 3.30% in Apr. We continue to expect inflationary pressures to rise on the back of an uptick in government-administered prices, particularly electricity tariff, as well as the removal of fuel subsidies in 2H 2017. These, together with the weaker domestic currency, should put upside pressure on consumer prices. Our economic team maintains its headline inflation forecast at 4.26 in 2017. This projection remains in line with the central bank's expectation for inflation to accelerate above 4.0% in 2017.

- **Monetary Policy Forecast:** The current policy stance has been in place since Oct 2016 with the 7-day reverse repo rate left unchanged at 4.75%. Both the lending facility and deposit facility rates were maintained at 5.5% and 4.00% respectively, leaving the interest rate corridor steady at 75bp on either side of the policy rate. The BI has kept its policy intact to anchor inflationary expectations, support growth momentum and maintain IDR stability. The front-loading of rate cuts (amounting to 150bp) in 2016 has provided BI with the monetary space to hold its benchmark rate steady amid further US Fed rate hikes and balance-sheet reduction, and threats of protectionism. Despite calls on some front to ease policy to lower lending cost and boosting growth, BI is expected to remain vigilant for the rest of the year given existing concerns about inflation arising from government-controlled prices, which has so far risen by 9.14% y/y in May. Our economic team believes that the BI will use macroeconomic-prudential policies to boost growth rather than the policy rate and keep the policy rate on hold for the rest of the year and in 2018.

- **Latest Fiscal and External Balance Outlook:** The government is in the process of finalizing revisions to the 2017 state budget before submitting to parliament for approval. The revision will take into account the government's requirement of IDR37-40tn of additional financing and also include additional spending of IDR10-20tn for critical needs, including preparation for the ASEAN Games and regional elections. More importantly, the budget deficit for 2017 will be widened to 2.6% of GDP from 2.41% previously but still below the statutory cap of 3% of GDP.

- The current account deficit (CAD) rose mildly to USD2.40bn in 1Q 2017 or 1.0% of GDP (4Q: -USD2.10bn or 0.9% of GDP) after slipping lower in 4Q 2016 to USD2.10bn. This mild deterioration was due to the larger deficit in the primary income account (1Q; -USD7.15bn vs.

4Q: -USD6.14bn) and smaller surplus in the secondary account (1Q; +USD0.78bn vs. 4Q: +USD0.93bn) that more than off the slight improvement in the goods and services account of USD4.23bn (4Q: USD3.11bn). The overall balance of payments surplus was little changed at USD4.51bn. The BI expects the BoP to remain in a surplus in 2017 but to moderate to USD8-9bn from USD12bn in 2016. This narrowing in the BoP surplus is due to declining capital and financial account and deficits in the current account (expected around 1.8-1.9% of GDP). For 2017, our economic team expects the CAD deteriorate to 1.15% of GDP due to greater import of capital goods to support the government's infrastructure programme, in line with the BI's outlook for 2017.

- **Key domestic events and issues to watch**: BI meets on 19-20 Jul to decide on monetary policy.
- **Technical Outlook:** USDIDR traded a tight range of 13270 – 13340 this month. Last seen at 13330 levels. Underlying momentum remains bearish bias but shorter term momentum shows signs of turning mild bullish. Next support remains at 13250. Resistance at 13400 (recent high). Expect recent range to hold with mild bias to the upside.

PHP: Still Underperforming

Forecast	2Q 2017	3Q 2017	4Q 2017	1Q 2018
USDPHP	50.30 (--)	50.50 (--)	50.70 (--)	50.70 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** The PHP continues to underperform, lingering at the bottom of the pile among its ASEAN peers. The PHP has fallen by nearly 1.6% against the USD so far in Jun, weighed by the rise in UST yields. The narrowing yield differential between the UST and Philippine government bond could be spurring outflows in search of higher returns elsewhere. Similarly, the potential for tightening bias in monetary policy in EU, UK and Canada is also lifting global bond yields and spurring fund outflows. This narrowing of yield differentials between global bonds and Philippines government bonds puts downside pressure on the PHP and keep the USDPHP supported above the 50-figure.
- Our house view is now for reflation trades to be delayed until 2H 2018. This means that any boost to the USD from tax reforms/fiscal spending will also be delayed. This moderation in USD strength is unlikely to significantly impact the PHP. Instead, the PHP remains weighed by both domestic and external concerns that are not easily offset by any benefits from a more moderate USD.

- We expect downside pressure on the PHP in the next three-to-six months to come from moves in UST yields. The expected resurgence in the UST yields amid further Fed rate hike in Sep on the back of the improvement in US economic fundamentals, as well as the likelihood of the Fed curbing their balance sheet by year-end. Meanwhile, expectations of policy normalization in the G7 economies, namely the EU, UK and Canada, could also lift global yields even higher. Higher returns outside of the Philippines then could see an exit from Philippine assets towards the G7 economies. This in turn should weigh on the PHP.

- Downside risks to the PHP are likely to be accentuated by the deteriorating current account. Recent data showed the current account deteriorated into deficit in 1Q 2017 of 0.4% of GDP in 1Q 2017, narrowing from 4Q's -1.2% of GDP. This was only the second time since 1Q 2012 that the current account has slipped into a deficit on a quarterly basis. The stronger import expansion – indicative of healthy domestic demand – in the past two quarters led the shift in the current account to a deficit. The slippage in the current account is expected to extend beyond 1Q. This is reflected in the BSP recent projection for the current account to slip into a deficit of USD600mn for 2017 vs. a surplus of USD800 projected earlier. This deterioration in the current account should weigh on the PHP until at least the end of 2017.

- Ongoing concerns about the President's anti-drug policy and declaration of martial law in Mindanao have left some foreign investors sitting on the sidelines, awaiting greater clarity before actualizing their investment decisions. Such policy uncertainties have dampened FDI inflows as reflected large contraction in FDI of USD1.83bn and USD1.14bn in 4Q 2016 and 1Q 2017 respectively. We therefore need to see a more nuanced dissipation of these risks before an improvement in the PHP can be realized. While indiscriminate killings are still being reported, signs that the campaign against illegal drugs is slowing. Similarly, martial law appears contained within Mindanao alone and does not seem to be extended to other parts of the Philippines for now. This should allay foreign investor concerns and could eventually lead to further foreign inflows into the Philippine assets and be supportive of the PHP. However, should martial law be extended country-wide, the USDPHP could climb higher by at least 5% from current levels in the lead-up to the imposition of martial law as suggested by our estimation of the THB moves during the recent martial law episode in Thailand.

- In the longer term, we could see more inflows into the Philippines equity market. This is because valuations in the Philippines have fallen after the sell-off in the equity market over the past few months. According to our estimates using the Cyclical Adjusted P/E (CAPE) ratio, equities are now relatively cheaper (as reflected by estimated P/E ratios minus their 5-year average P/E ratios) compared to its peers and this could eventually attract foreign inflows as a result. We are already seeing portfolio inflows to Philippine assets with foreign investors purchasing USD362.96mn in equities in Jun-to-date, more than doubled the USD172.96mn bought for the whole of

May. Further inflows should go some ways to mitigating some of the downside risks to the PHP and lift support the PHP higher in 2Q 2018.

- Our economic team continues to expect the BSP to be the first in the region to hike its benchmark policy rate by 25bp. This is to keep the economy from overheating and for inflation to stay within the BSP comfort zone of 2-4%. The rate is expected to take place in 2H 2017 after the new governor takes office on 3 Jul. Meanwhile, the expected passage of the first phase of the tax reform program by late Jul to Aug and become law by end-2017 could bolster sentiments and hence the PHP but we expect the impact on the PHP to be temporary. This is because we believe that the tax reform has mostly been priced in already when the bill cleared the House of Representatives at end-May. Thus, the 25bp lift to short-term rates and the tax reforms are unlikely to be a panacea for its current currency woes. We can expect the USDPHP to continue to climb higher from 50.50 by end-3Q 2017 to hover around 50.70 by end-2017 and in 1Q 2018.

- Our monthly **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, improved to 5.0 from 5.2. This improvement could be attributed to decrease in GDP and fiscal risks. This should be supportive of the intrinsic value of the PHP.

- **Growth and Inflation Outlook:** Despite GDP growth easing slightly in 1Q 2017 to 6.4% from 6.6% in 4Q 2016, the economy continues to be firing from all cylinders. Consumer spending is likely to remain healthy in 2Q, extending the gains in 1Q amid a tight labour market and rising wages. There are however some concerns that overseas remittances could slip further because of the ongoing tensions between Qatar and the rest of the Gulf Cooperation Council members. Overseas remittances had contracted by 5.9% y/y after rising by 10.7% in Mar. In the first four months of 2017, remittances have risen by just 4.2% y/y, off the 5% pace seen in the whole of 2016. Meanwhile, the synchronized export recovery in the region has lifted exports with exports rising by double digits in Mar and Apr. In the first four months of 2017, exports have risen by 15.3% y/y and are likely to see the first expansion after contracting in both 2015 and 2016. Not surprisingly, the government remains optimistic over the economic prospects, even though bulk of the planned infrastructure spending could only come in next year. The government continues to target growth of 6.5-7.5% for 2017. Similarly, our economic team expects the economy to expand by 6.4% for 2017, just a tad below the lower bound of the government's 6.5-7.5% growth projection.

- Headline inflation had some relief in May, moderating to 3.1% y/y from 3.4% in Apr. Core inflation meanwhile inched lower to 2.9% y/y in May from Apr's 3.0%. The main culprit for the climb in headline inflation was food prices, which rose 4.2% y/y in Apr from 3.4% in Mar. The moderation in inflation could be attributed to lower food prices, which rose by 3.8% y/y in May from 4.2% in Apr, and transport cost which slowed to 2.7% y/y in May from Apr's 3.2%. In the first five months of the year, headline and core inflation continued to average 3.2% and 2.8% y/y respectively. Our economic team maintains its 2017 and 2018 headline inflation forecasts at 3.3% and 3.5% respectively prices to reflect primarily changes in domestic tax policies and supply-side factors affecting prices of necessities like food, fuel, power and public transport.

- **Monetary Policy Forecast:** The BSP has maintained the status quo in its policy stance since 16 May 2016 with its policy rate left unchanged at 3.0%. Also kept steady were the overnight lending rate and overnight deposit rate at 3.5% and 2.5% respectively, which in turn, kept the 50bp symmetrical corridor on either side of the policy rate in place. However, our economic team expects the BSP to be the first central bank in the region to hike rates in 2017 given the outperformance of the economy - expanding at a healthy pace above 6% - and inflation accelerating close to the upper bound of the government's comfort zone for inflation. At the same time, the BSP is also likely to be mindful about the narrowing gap between UST and Philippines treasury yields as the US Fed continues its rate normalization in 2017 that could spur capital outflow. Our economic team expects the central bank to hike the policy rate by 25bp rate hike once sometime in 2H 2017 after the new governor, Nestor Espenilla Jr takes office on 3 Jul. This modest rate adjustment should ensure that real interest rate remain positive, though we doubt that this would be sufficient to ease downside pressure on the PHP.

- **Latest Fiscal and External Balance Outlook:** Press reports suggest that the government is mulling plans to borrow PHP195bn in 3Q 2017, up from 2Q's PHP108bn. This borrowing consists of PHP105bn in treasury bills and PHP90bn in treasury bonds. These issuances are expected to help fund infrastructure projects. At the same time, the budget deficit rose to PHP33.4bn in May, underpinned by stronger spending (up 20% y/y) vs. revenues (up 14% y/y). For the first five months of the year, the budget deficit came in at PHP63.6bn, almost doubled that in the first four months of the year (-PHP30.18bn). Despite the expected rise in the budget deficit, the government intends to cap the deficit at 3% of GDP this year as well as into 2022.

- The recovery in the balance of payments (BoP) back into a surplus position in Apr proved to be short-lived. The BoP slipped back into a deficit of USD0.06bn in May, though this was an improvement over the deficit of USD917mn in Apr. Detailed breakdown of the components of the BoP is unavailable for now but we can infer from this slippage that both the current account and financial account balances deteriorated in May. The deficit in the current account is likely to be due to the deficit in the merchandised goods account and also possibly from the narrower surplus in the income account. As for the financial account, the deficit could be due to portfolio outflows as well as a deficit in the 'other investment' account in May. As expected, the BSP revised down their projection for both the overall BoP and current account balances. The central bank now expects a deficit of USD500mn and USD600mn for both the overall BoP and current account in 2017. Previously, the BSP had been expecting an overall BoP and current account surplus of USD1bn and USD800mn respectively in 2017. The projected deficit in the current account is the first deficit in 15 years the BSP now expected to revise these projections sometime in Jun to take into account development in exports, remittances and investment flows.

- **Key domestic events and issues to watch:** The tax reform bill will come under consideration in the Senate, which reconvenes on 24 Jul, following its passage in the House of Representative at the end of May. On 3 Jul, current central bank deputy governor Nestor Espenilla Jr will take over as governor of the BSP on 3 Jul.
- **Technical Outlook:** USDPHP continued to trade higher, pushing through to 8-year high. Last seen at 50.54 levels. We caution that a decisive move beyond this level should see the pair trade much higher towards 52.55 (76.4% fibo retracement of 2006 high to 2008 low). Support at 50 (100 DMA), 49.85 (21, 50 DMAs). Bias to buy on dips to test 52-handle.

THB: Supported By Portfolio Inflows

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDTHB	34.50 (35.30)	35.00 (36.00)	35.30 (36.20)	35.80 (--)

Previous forecasts in parenthesis

- **Motivation for the FX View:** The THB remains one of the best performing Asian currency in Jun, rising by 0.24% against the USD. The lack of progress by the US on tax reforms/infrastructure spending means that any additional boost to the USD will be pushed back. In addition, the increasing likelihood of tightening biases by the ECB, BOE and BOC should lift their currencies and weighed on the USD. Though the USD trajectory remains intact, we expect the pace of USD gains will be gentler. Softer USD aside, the search for higher returns amid fading global reflation trades should continue to spur inflows into Thai assets, helping to keep the THB supported in the month. Taken together, we now expect the THB move lower to be more moderate, but our overall bearish outlook for the THB is maintained.
- Our bearish THB view is premised on our expectations that the political situation in Thailand will deteriorate towards the end of the year. The importance of the political environment cannot be understated. Our study using VAR decomposition analysis (which shows the percentage of the forecast variance due to each endogenous variable) highlighted the political environment as the most important factor impacting the USDTHB. For now, the current political calm in the kingdom is providing the impetus for an economic growth recovery and investment inflows, providing support for the THB moves below the 34-levels. However, political sentiments are likely to deteriorate as the election schedule becomes clearer towards the end of the year.
- The political calm and stability is expected to extend to the funeral of the late King HM Bhumibol, which is expected sometime in Nov, and the coronation of HM King Maha Vajiralongkorn, which should follow

soon after. Once these ceremonies are concluded and the election scheduled revealed, simmering tensions are likely to resurface. The focus of this tension is the continued dominant role of the military (and the elites) in the political arena to the exclusion of nearly everyone else. Of import is the new constitution which gives the military the power to appoint 250 members of the new Senate in the first five years after the first parliament convenes. In addition, the new constitution allows for the appointment of a non-elected PM to head the government especially in a divided lower house of parliament. These powers would allow the military and its allies to dominate the political arena long after civilian rule has been reinstated. Consequently, political temperature could flare in the run up to the general elections, expected sometime mid-2018. Political uncertainty ahead of the general elections could keep foreign investors on the sidelines until there is clarity on the political front. This could weigh on THB sentiments and support the USDTHB around the 35-handle by the end of the year.

- Additionally, there is a risk that market is underpricing US Fed tightening bias. Aside from the final rate hike for 2017 in Sep, we are also expecting the Fed to reduce its balance-sheet by year-end. There could thus be a sharper upswing in UST yields, sparking a sell-off in EM assets, including those from Thailand. This could put upside pressure on the USDTHB. Meanwhile, expectations of policy normalization in the EU, UK and Canada should lift global yields even higher, narrowing the returns between Thai assets and these G7 economies. Consequently, there could see portfolio outflows from Thailand that could weigh on the THB.

- Mitigating some of these downside risks to the THB are positive real yields, strong inflows into government debt and current account surpluses. The widening of real yield differentials between the 10Y UST and Thai government bond (47 pips at the point of writing) should still encourage capital inflows in search of higher returns, lifting the THB higher. Relative low foreign ownership in Thailand at 15% (compared to Indonesia at 38% as of end-Mar 2017) suggests that there is room for even more foreign ownership of Thai assets. This continues to make Thai bonds more attractive than Indonesian ones, and continue to provide support for the THB. In addition, the persistent current account surplus should act as a backstop to any aggressive THB moves lower. With the exception of Singapore, which historically has persistent and high current account surpluses, Thailand has seen its current account surplus balloon to more than 10% of GDP since 2014. In contrast, the current account surpluses of both Malaysia and Philippines are tapering, while Indonesia continues to see persistent current account deficits. Still, the narrowing current account surplus could provide cause for investors to pause, limiting upside to the THB.

- Reflecting these positive elements are the strong portfolio flows so far this year. For the year so far, foreign investors have purchased THB13.61bn and THB158.59bn of equities and government bonds compared to THB77.91bn and THB330.96bn respectively for the whole of 2016. On a monthly basis, foreign investors have purchased THB18.86bn of government bonds (vs. THB37.86bn in 2016), but marginally sold off of THB6.28mn in equities as compared to the THB5.52bn purchased in 2016. Further purchases by foreign investors in the months should be supportive of the THB, capping upside to the USDTHB.

- We have tweaked our USDTHB forecast to reflect the more moderate USD trajectory resulting from fading reflation trades. We now expect the USDTHB to still climb higher but at a more moderate pace than previously expected. The USDTHB is now expected to end-3Q and -2017 at 34.50 and 35.00 vs. previous forecast of 35.30 and 36.00 before heading higher to 35.30 (36.20 previously) and 35.80 on political concerns.

- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Thailand deteriorated to 4.7 from 4.0. This was due to deterioration in current account and fiscal risks that completely offset the improvement in inflation risk. This should weigh on the intrinsic value of the THB.

- **Growth and Inflation Outlook:** The economy remains on the modest recovery path as reflected in recent high frequency data. Private consumption, business sentiments and consumer confidence have all picked up by 2.3%, 5.2% and 4.7% y/y in May, signaling healthy domestic demand. At the same time, external demand is also supportive of the economy with exports rising by 10.6% y/y in May. Our economic team continues to be optimistic about growth prospects in 2017. They expect improvement in consumption spending and exports to reinforce the higher public investment and tourist arrivals. Our economic team is looking for full-year growth to come in at 4.0% for 2017, an above-consensus forecast and higher than the BoT's 3.4%.

- The economy returned to disinflation in May with headline inflation falling by 0.04% y/y in May from 0.38% in Apr. The decline in inflation was due to a larger drop in food prices, which fell by 1.38% y/y in May from Apr's -0.26%. Core inflation moderated further in May, rising by 0.46% y/y in May from 0.50% in Apr. Despite the lack of traction in inflation so far, our economic team expects inflationary pressures to return later this year on the back of low base effects, higher energy/fuel prices, improving domestic demand amid a weaker THB. They continue to expect inflation to average 2.5% in 2017, significantly higher than the 1.2% projected by the BoT.

- **Monetary Policy Forecast:** The BoT has been on hold since 29 Apr 2015, the last time the benchmark interest rate was cut by 25bp to 1.50%. The last time the policy rate was even lower than this was during the Great Financial Crisis in 2009-10 when the rate was cut by 25bp to 1.25%. Though the IMF has called for further rate cuts, the BoT considers the current monetary policy to be accommodative enough and further adjustments to the policy rate is unnecessary at this point in time. The BoT views expansionary fiscal policy to be the appropriate driver of economic growth with monetary policy playing a supportive and complementary role to fiscal policy.

- That said, our economic team believes that the central bank could hike its benchmark policy rate to anchor inflationary expectations and to prevent the economy from overheating sometime in 2017. At the same time, a rate hike would also lift domestic yields, keeping the current spread between the UST and Thai bonds or widen it, helping to reduce any outflow from Thai assets. Our economic team is thus penciling two 25bp rate hikes to lift the benchmark policy rate to 2.0% by end-2017.

- Rate normalization aside, the BoT is also concerned about the strength of the THB as a result of hot money inflows into Thai assets. The central bank governor had warned that BoT was ready to introduce further measures to curb such inflows to stem the strength of the THB 'without advance notice'. Already, the BoT has taken steps in Apr to reduce the supply of 3-months and 6-months bond supply in May to curb inflows. These curbs on short-term bond supply have been extended for a second month into Jul. The central bank has also introduced changes to existing regulations to reform foreign exchange regulation.

- The BoT rule relaxations released on 5 Jun, included: (1) granting FX licenses to brokerages to buy/sell foreign exchange for locals and foreigners; (2) bank lending to non-resident investing in Thailand no longer require central bank approval; (3) money changers can buy/sell foreign exchange with foreign banks and other money changers; and (4) individuals with assets of THB50-100mn can invest in securities abroad directly with limit of USD1m a year. It is not clear exactly when these rules will take effect but according to news reports, some will take effect in Jun while others at the end of the year. Instead of addressing THB strength, these rule changes appear to be aimed at lowering the cost of doing business. In the longer term, these measures should encourage greater outflows in search of higher returns, as yield differentials between the UST and Thai government bonds narrow as the Fed continue its rate normalization and balance-sheet reduction.

- **Latest Fiscal and External Balance Outlook:** The Finance Ministry is working on legislation to legally bind future governments on thresholds for key budget variables. The planned law would seek to limit public debt to GDP, cap fiscal deficit at 3% of GDP and earmark 20-25% of the state budget for investment outlays.

- The current account surplus continued to narrow for the third consecutive month. In May, the surplus moderated to USD1.13bn in May from THB2.91bn in Apr, due to the deficit of USD1.10bn in the primary and secondary income account (Apr: +USD1.46bn). Despite the surplus in the current account, the overall balance of payments (BoP) slipped into a deficit for only the second time this year at USD1.63bn in Apr, possibly due to a deficit in the 'others' segment of the financial account.

- **Key domestic events and issues to watch:** The BoT meets on 5 Jul to decide on monetary policy.

- **Technical Outlook:** USDTHB traded low of 33.80 in Jun before seeing mild rebound into month-end. Pair was last seen at 34 levels. We observed bullish divergence on daily chart and expect the pair to rebound towards 34.20 (38.2% fibo retracement of May high to Jun low), 34.32 (50% fibo) and 34.44 (61.8% fibo). Support remains at 33.80. Bias to buy dips.

INR: Bracing for GST

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDINR	65.70 (--)	66.20 (--)	66.50 (66.00)	66.70 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Spot price is seen around 64.50, right around where we have left it one month ago as we wrote the last FX monthly. Positive sentiments around the GST roll-out on 1 Jul are likely to be built into the equity and bond markets already and we are more wary of teething issues that could generate some uncertainties as we move into the next quarter. The inflow of equities has slowed markedly but bond-related inflows rose to U$3.14 (mtd 27 Jun). RBI has been intervening in the forex markets, buying USD to "smooth volatility". RBI made a net forward purchase of USD13.5bn in Apr. We continue to see potential bearish factors including upmove in USD, slower inflow of bond-related flows and potential uncertainties emanating from the GST implementation to weigh on sentiments into the next quarter. We look for USDINR to head towards 65.70 before a potential move lower towards 65.20 as seasonal drivers turn. We expect rupee to withstand US tightening better than its peers.

- *Fresh Endeavour:* The RBI has moved ahead with its fresh executive authority to resolve bad assets in the banking system and Governor Patel is even vocal about making the resolution of non-performing assets and recapitalization of PSBs as a priority. That will strengthen the monetary transmission. RBI started by releasing a series of measures including getting a panel to ensure a consistent decision making process for cases that may be determined for resolution under India's rules on insolvency and bankruptcy and to increase the number of members in the Oversight Committee that deals with stressed assets. Next, it has also required a rather sharp increase in provisioning for loans being referred to bankruptcy courts. The central bank asked banks to set aside at least 50% of loan amount as likely losses for cases in insolvency process. The provisioning requirement is raised to 100% for cases that do not get resolved within the initial mandatory period and subsequently forced into liquidation. Deputy Governor SS. Mundra has already flagged that state-run banks may need more recapitalization than what is already allocated by the budget. This latest endeavour by RBI could help to raise credit growth and private investment that has been lacking in the economy.

- *GST Roll-Out:* The GST committee has taken special care to keep price pressure in check with a 4-tier GST rates system along +

exemptions. Theoretically, with most food essentials (fresh food, fresh milk) exempted, the impact on inflation should be minimal and overall. The four tax rates – 5, 12, 18 and 28%+cess that is also applicable on services have also meant to ensure that the taxes are revenue-neutral. However, the exemptions and multi-tax rates could mean that the GST system is less efficient and more administratively cumbersome than a simple single rate tax system. We concur with our India equity strategist that the major benefit is that in the medium to long term, it is expected to improve tax compliance and GDP growth, by 100-150bps (their estimates). Greater uniformity of tax will also enhance the ease of doing business. What we are more concerned is the short-term execution and adjustment could still be an issue as a vast number of SMEs are required to adopt the digital system and equipment and the multi-tax rate system could mean that revenue collection is likely to administratively cumbersome and could even distort spending behavior.

- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for India deteriorated to 4.6 (with 1 being the best score and 9 being the worst) from previous 4.4 as the improvement in the score for fiscal was outweighed by the deterioration in GDP.

- **Growth and Inflation Outlook:** 1Q GDP came in softer than expected at 6.1%y/y from previous 7.0%, weighed by the fall in GFCF by -2.1%. Private consumption slowed to 7.3%y/y from previous 11.1% though government spending was able to underpin the headline with a 31.9%y/y growth. Looking at the breakdown across industries, lower output was recorded for most including mining and quarrying, manufacturing, electricity, gas, water & other utilities, construction. Services saw larger contribution of 3.74ppt to headline GVA of 5.57%y/y. Demonetisation took the blame for the slowdown. India was not left out of the synchronized exports recovery that the region had seen in Jan-Apr though trade growth saw significant moderation in May. Exports slowed to 4.3%y/y from previous 14.4% (rupee terms). Imports growth also came off from 42.5% to 28.2%. Industrial production for Apr moderated to 3.1%y/y growth from the previous 3.8% (which was revised higher), underpinned by firmer output growth from manufacturing while those of mining and electricity slowed.

- CPI slowed further to 2.18%y/y from previous 2.99%y/y. Price pressure came off across the board and food saw a decline of -1.0%y/y for May due to a supply glut issue especially in pulses and vegetables, owed to a strong spring harvest. WPI also trends lower with fuel and power subcomponent coming off sharply. The headline slipped to 2.2%y/y from previous 3.9%, weighed also by food, mineral and manufacture products. With the southwest monsoon rainfall forecasted to be near normal, price pressure of food should be benign and that should cap CPI in the months ahead.

- The latest industrial outlook survey released in Jun reveals further improvement in sentiments on demand conditions including production, order books, capacity utilization, exports and employment this quarter. The uptrend in these aspects are all expected to hold into the present quarter (Q1:2017-18).

Manufacturers remain pessimistic on the cost of raw materials but optimistic about the selling price. Overall, respondents are not optimistic about profit margin. With capacity utilization heading higher,

- **Monetary Policy Forecast:** The next RBI meeting is in Aug and so we are in for a quieter month ahead, save for possible teething issues to the GST roll out on 1 Jul that should be monitored. Minutes of the Jun meeting revealed wide acknowledgements that inflation has come off due to strong rabi harvest that resulted in a food supply glut. Wholesale price index, on the other hand, was weighed by the persistent declines in crude prices over the past few months. While brent has risen from its recent lows, anticipate that inflation prints are still likely to remain subdued for a while before ticking higher. In the meantime, the monsoon season is coming along nicely with the India Meteorological Department still expecting a normal and well-distributed rainfall that should boost the agriculture output. Members of the RBI MPC committee were still watchful of upside risks to inflation stemming from rising rural wage growth, concomitant consumption demand, fiscal slippages and a possible disbursement of allowances under the 7th central pay commission's award. One member, Dr. Ravindra H. Dholakia had dissented from the rate-hold decision, recommending a 50bps cut to the policy rate to 5.75%. Recall that RBI Patel also desires a lower policy rate as he flagged that there is still room for banks to cut lending rates at the Apr meeting. With private investment persistently sluggish, we look for RBI to keep policy rate unchanged at the next policy meeting on 2 Aug with risks tilted to a 50bps cut in the following meeting on Oct once RBI has made more progress to resolve NPLs and started recapitalizing lenders.

- **Latest Fiscal and External Balance Outlook:** The Union Budget is pro-rural. Finance Minister Jaitley pledged support to the farmers, infrastructure spending and personal income tax cuts and corporate tax cuts for small and medium businesses to boost consumption and investment. Investors will closely watch for the implementation of the GST, scheduled on 1 Jul. As stated above, our equity strategists estimate a 100-150bps boost to growth from the implementation.

- The current account deficit narrowed to $3.4bn in the quarter ending Mar 2017. Trade deficit narrowed to U$29.7bn vs. previous U$33.3bn. Capital account recorded an inflow of U$23.5bn. Portfolio investment also recorded a net inflow of U$10.8bn, lending strong support to the rupee. Expect some moderation in inflow for the next quarter but current account deficit should remain within 1% of GDP.

- **Key domestic events and issues to watch:** GST rollout on 1st Jul, PMI is due on the 3rd Jun, trade on 10-17th, CPI and industrial production on the 12th, WPI on 14th.

- **Technical Outlook:** The USDINR 1M NDF seems to be building a rounding bottom on the weekly chart as we write. Last seen around 64.90, we see more risks to the upside at this point with a break of the 65.25 required before the next resistance at 65.90 (38.2% Fibonacci of the 2017 sell-off so far).

VND: Stable As Long As the USD Does Not Turn

Forecast	3Q 2017	4Q 2017	1Q 2018	2Q 2018
USDVND	22850 (23100)	22950 (23300)	23100 (23400)	23300 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The lack of USD strength has left USDVND within the 22650-22760 range. The stability in the dong has also capped price pressures, also helped by the downtrend in food prices as well as the fall in fuel prices in the region. While portfolio flows have moderated, there was a surge in FDI inflows in Jun. This could continue to generate income for Vietnam as well as provide some cushion for the VND from external depreciation pressures. That said, moves in Jun were slightly biased to the upside, sensitive to any signs of rebounds in the USD. We still see mild upside risks to the USD, especially against the USDAsians, though our levels are calibrated lower to take into account the downdrift in the USD. The bids in USDVND in a stronger USD environment could be aggressive and we see it as a matter of when, not if. An upside trajectory is expected to lift the USDVND towards 22950 by year end.

- **Growth and Inflation Outlook:** Growth picked pace in the second quarter and GDP for the first half of the year came in at 5.73%y/y from previous 5.10% on the back of strong exports and surge in credit growth. Agricultural recovery seems to be on track as well. Manufacturing saw output accelerating from 8.3%y/y in the first quarter to 10.5% in the first half of the year. For the same period, services industry also accelerated to 6.8%y/y from 6.5% in Jan-Mar. Looking ahead, May PMI-mfg suggests that manufacturing sector might see some loss in momentum with a print of 51.6 vs. the previous 54.1. That has not shown up in the industrial production numbers yet for Jun with 8.6%y/y growth vs. 7.2% in the month prior. The PMI-mfg report also signaled slower expansion in output and new orders whilst output prices fall along with cost inflation. Retail sales remained steadied around 10.1%y/y for the first six months, vs. 10.2% in the first five months, supported by a rising middle class. Vietnam has been experiencing strong tourist arrivals in the past few months including Jun and that should continue to underpin private consumption.

- Inflation softened towards 2.54%y/y for Jun from 3.19% in the month prior, tempered by the stability in the Vietnamese dong and a fall in food inflation. The slow-down was actually broad-based but particularly significant decline was seen in the food sub-component, which recorded a fall of -3.1%y/y. Transport decelerated markedly to 4.22%y/y from previous 8.10%, possibly weighed by the decline in crude prices. We recall that the Head of GSO Price Statistics Department urged Ministries to keep an eye on prices of essential goods in particular rice, gasoline, steel and fertilizer in order to keep CPI below 4%. Food inflation may be low now but any rise in fuel prices, coupled with a weak dong (that is derailed by a resurgence of USD) could threaten the headline CPI to the upside. The Ministry of Planning and Investment's National Centre for Socio-Economic Information and Forecast expects inflation to average around 4.7% in 2Q with potential weakness in dong likely to keep price pressure.

- PM Nguyen Xuan Phuc said he is confident economic growth this year will meet the target of 6.7% without threatening the inflation target of 4%. The acceleration in exports, foreign investment and agriculture production should foster stronger growth in 3Q and 4Q. More recently, earlier this month, the National Financial Supervisory Commission said that inflation rate is seen around 2.6% for this year if prices of worldwide commodities and local public services remain stable.
- **Monetary Policy Forecast:** The National Assembly passed a resolution on Jun 21 that allows bad debt to be bought and transferred with special bonds into bad debts at market prices under the guidance of the SBV. The resolution will be implemented within 5 years from 15 Aug 2017. This could ensure an improvement in monetary transmission system. We continue to expect little action from SBV in terms of rates and since credit growth has been picking up strongly to 20.1%y/y in Apr. The SBV had stated earlier this year to ensure stable interest rate and stand ready to respond to any extraordinary movement. The SBV would strictly monitor and promptly intervene when needed through open market operations and refinancing to manage money supply.
- With USD remaining on a sluggish trend, USDVND could remain at the current range. However, we are still wary of risks of higher US rates which should keep USDVND supported on dips. SBV is likely to keep policy rates (currently base rate at 9.0%, refinancing rate at 6.5% and discount rate at 4.5%). USDVND could continue to keep a mild uptrend into 2Q and 3Q. Resurgence in USD strength would still leave USDVND vulnerable to the upside. Lean FX reserves-import ratio of barely above 2 would mean that any external shocks in the FX space could force SBV to devalue the dong. Should USD remain on the upmove, expect USDVND reference rate to be fixed higher and that should guide the USDVND towards our 22950 forecast by 4Q.
- **Latest Fiscal and External Balance Outlook:** Little development on this front. Vietnam reported a state deficit of VND21.8trn from Jan-Mid May, that's 5.64% of GDP in the first five months. Expenditure on infrastructure is slow according to the Chairman of national Assembly Economic Committee. Recall that in April, Vietnam set a lower budget deficit of 3.38% of GDP for 2017 from previously 3.50%. 2016-18 public debt (including government debt, debt guaranteed by government, municipal debt) is capped at 65% of GDP. 2016-18 government debt is set at no more than 54% of GDP while foreign debt is set at no more than 50% of GDP. The government has an ongoing effort to divest VND67trn from SOE in the years leading to 2020. Key use of the capital is to develop important infrastructure projects like the Long Thanh International airport, along with the recent plans to build the Chrey Thom Bridge that will connect the southern province of An Giang in Vietnam to Cambodia's Kandal province. This is meant to promote bilateral trade and bring about more economic benefits for those communities along the border areas. That said, there was no

timeframe for the construction. Flow-wise, we see an improvement as there was exceptionally strong FDI inflows in Jun that drove the ytd growth to 57.9%y/y from previous -11.4%y/y for the first five months.

- Current account recorded a surplus of U$155mn in 4Q (latest data available), narrowing drastically from the U$3.5bn seen in 3Q on the back of narrower net trade surplus of goods. Expect 1Q 2017 print to possibly dip into deficit but more recent trade numbers suggest that Vietnam's external position should improve in the past quarter.

- **Key Domestic Events and Issues to Watch:** PMI-mfg is due on 3rd Jul. Jul CPI is due on the 24th. Jul Trade balance, industrial production and retail sales within 25-31st.

- **Technical Outlook:** USDVND hovered within 22650-22770 for much of Jun. The weekly chart indicates waning bearish momentum and stochs are also rising. We see mild upside risk with key resistance level seen around 22760 that could bring the pair towards the year high of 22850. Support is seen around 22650 (61.8% Fibonacci retracement of the Oct – Mar rally).

FX Forecasts

	End Q3-17	End Q4-17	End Q1-18	End Q2-18
USD/JPY	115	117	117	119
EUR/USD	1.1250	1.1400	1.1500	1.1300
GBP/USD	1.3200	1.3000	1.2900	1.3200
AUD/USD	0.7600	0.8000	0.7800	0.7600
NZD/USD	0.7300	0.7500	0.7700	0.7600
USD/SGD	1.3900	1.3800	1.3950	1.4050
USD/MYR	4.2500	4.3000	4.3000	4.2500
USD/IDR	13400	13450	13500	13500
USD/THB	34.50	35.00	35.30	35.80
USD/PHP	50.50	50.70	50.70	50.30
USD/CNY	6.80	6.87	6.85	6.90
USD/HKD	7.80	7.80	7.80	7.80
USD/TWD	31.00	31.00	31.50	32.00
USD/KRW	1150	1160	1170	1180
USD/INR	65.70	66.20	66.50	66.70
USD/VND	22850	22950	23100	23300
DXY Index	98.09	97.70	97.05	97.97
SGD Crosses	End Q3-17	End Q4-17	End Q1-18	End Q2-18
100 JPY/SGD	1.2087	1.1795	1.1923	1.1807
EUR/SGD	1.5638	1.5732	1.6043	1.5877
GBP/SGD	1.8348	1.7940	1.7996	1.8546
AUD/SGD	1.0564	1.1040	1.0881	1.0678
NZD/SGD	1.0147	1.0350	1.0742	1.0678
SGD/MYR	3.0576	3.1159	3.0824	3.0249
SGD/IDR	9640	9746	9677	9609
SGD/THB	24.82	25.36	25.30	25.48
SGD/PHP	36.33	36.74	36.34	35.80
SGD/CNY	4.89	4.98	4.91	4.91
SGD/HKD	5.61	5.65	5.59	5.55
SGD/TWD	22.30	22.46	22.58	22.78
SGD/KRW	827	841	839	840
SGD/INR	47.27	47.97	47.67	47.47
MYR Crosses	End Q3-17	End Q4-17	End Q1-18	End Q2-18
EUR/MYR	4.78	4.90	4.95	4.80
JPY/MYR	3.70	3.68	3.68	3.57
MYR/HKD	1.84	1.81	1.81	1.84
MYR/CNY	1.60	1.60	1.59	1.62
GBP/MYR	5.61	5.59	5.55	5.61
AUD/MYR	3.23	3.44	3.35	3.23
NZD/MYR	3.10	3.23	3.31	3.23
MYR/IDR	3152.94	3127.91	3139.53	3176.47
MYR/INR	15.46	15.40	15.47	15.69
MYR/KRW	270.59	269.77	272.09	277.65
MYR/PHP	11.88	11.79	11.79	11.84
CNY/MYR	0.6250	0.6259	0.6277	0.6159

Source: Maybank FX Research as of 30 Jun 2017

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

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