Jun 29, 2018

Maybank

FX Monthly

2018, Issue 6: Trade Deliberations Matter

What Has Changed This Month?

- We revised all our currency forecasts lower against the USD. USD strength is more pronounced against the AXJ currencies compared to the DM FX in light of the current US-China trade tensions amid monetary policy normalization. Also, we take into account ongoing political concerns in the EU/UK, rapid pace of RMB depreciation and latent fears of capital outflow from Asia.

Our Strategies

- Taking stock of our last FX Monthly, the pullback in the USD that we warned for the first week of Jun materialized. The subsequent rebound in the USD was also anticipated but the magnitude of the move surprised, especially against the AxJ FX.

- USD likely to remain mixed for the remainder of 2018. Against the majors we expect to see a milder downtrend likely to remain in place for second half of 2018 but we do not rule out bouts of USD strength like what we had witnessed in the past few months. Against the emerging market and regional currencies we expect the dollar to remain strong due to concerns of ongoing trade tensions amid tighter monetary conditions globally.

- If oil prices continue to rise and if there is a significant escalation of US-China trade tensions - we could see higher financial volatility and eventually some effects on global growth. Protectionist measures, if exacerbated, could potentially be inflationary along with the higher oil prices could weigh on growth momentum.

- Monetary policy convergence is still a theme to strategically position for into 4Q. Higher energy and commodity prices as well as tightness in labor market in other developed world including UK, AU and EU should feed through to inflation and brings back the case of policy convergence at a later stage. This scenario would see other currencies' strength play catch-up. We see opportunities to buy EUR, AUD and GBP on dips.

- Given monetary policy moves in ASEAN over the past six months, Thailand remains the laggard and its failure to move could see the THB lag its regional peers. Relative plays could be supportive of the PHP vs. THB. THB, MYR and the SGD have the highest correlation with the CNY, but the IDR, PHP, TWD and KRW are also becoming increasing correlated.

- Given stretched technical conditions, we see opportunities to short USDCAD (1.2930) in view of negative crude oil supply conditions and potential rate hike speculation in Jul, USDTHB(32.80), 1M USDKRW NDF (1092), USDPHP (52.70).

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FX Forecast Revision

Upward	Downward
USD	All Currencies

Top 3 Currency Plays for Jul

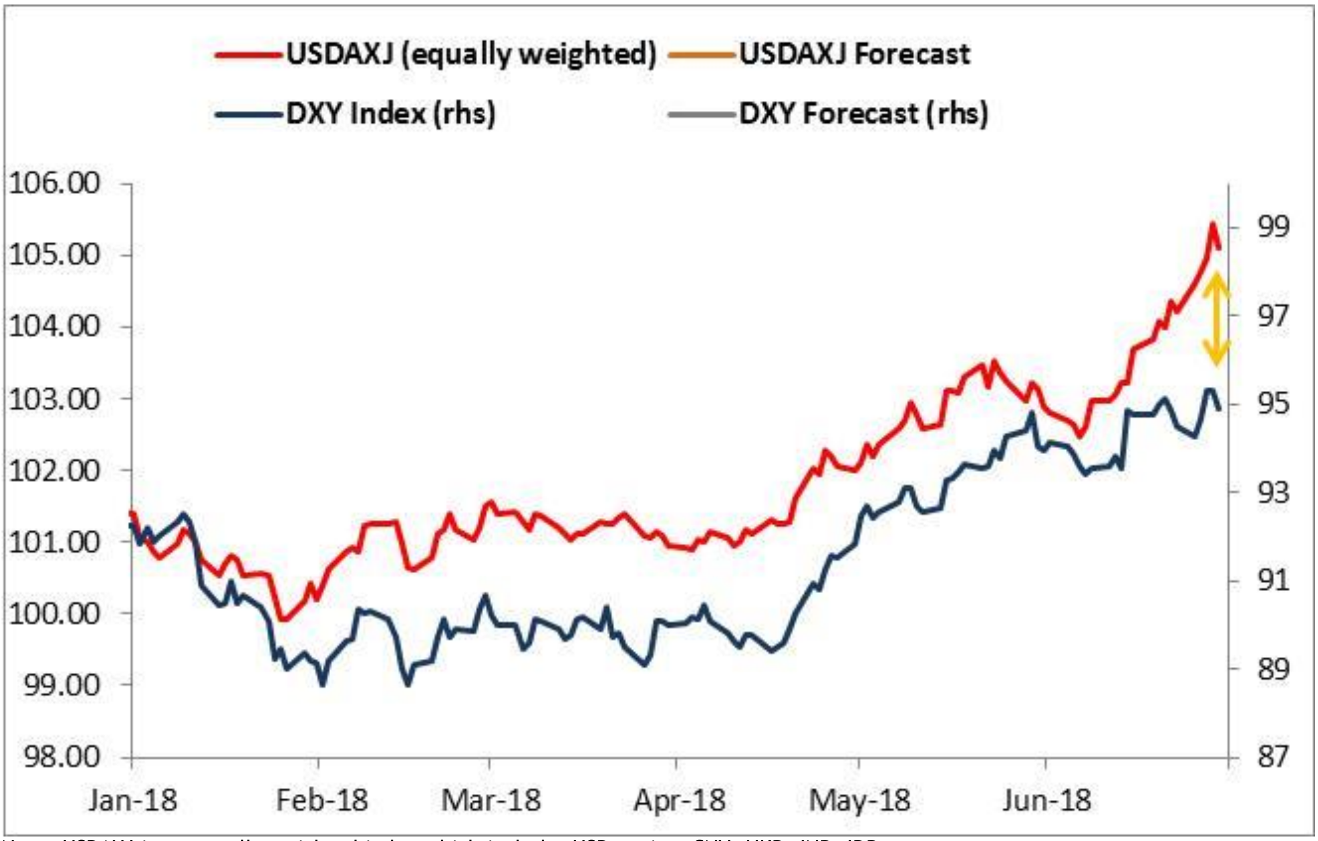
- Bias to Buy EUR on dips towards 1.14-1.15 levels for move towards 1.25
- Accumulate USD, EUR, JPY against AXJ FX
- Short USDCAD on fundamental and technical considerations

Key Events for the Month Ahead

Date	Event
1 Jul	RCEP Ministerial Meeting in Tokyo
6 Jul	US/China Trade Tariff on U$34bn of imports to take effect
11 Jul	BNM Meeting

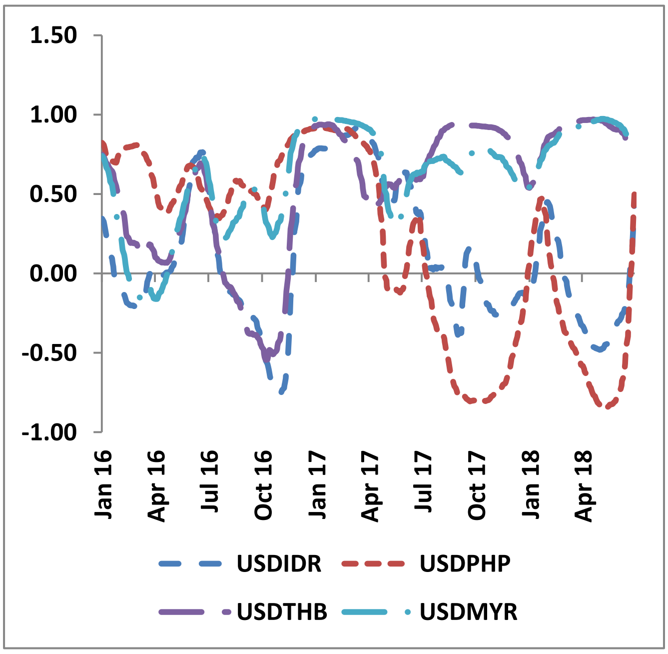
SEE PAGE 55 FOR IMPORTANT DISCLOSURES.

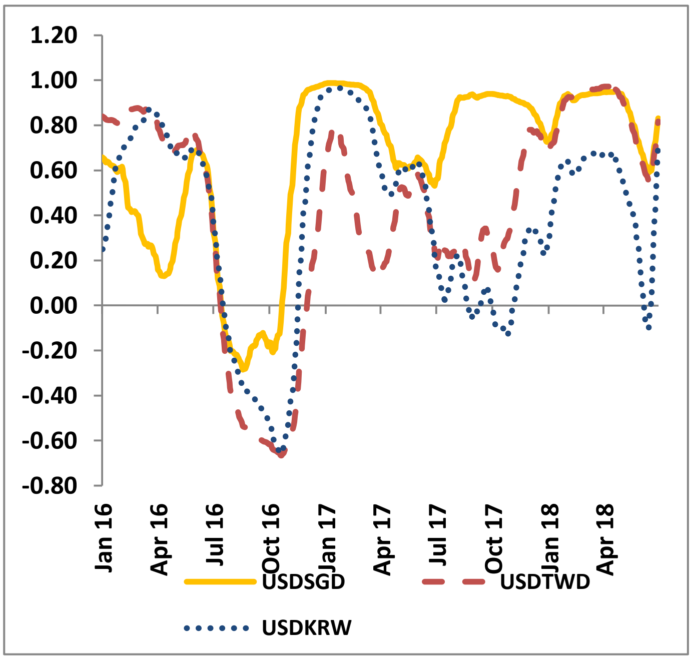
USD Strength To Be More Pronounced Against the AXJs Rather Than G7 In the Near Term



Note: USDAXJ is an equally weighted index which includes USD against CNY, HKD, INR, IDR, KRW, MYR, PHP, SGD, TWD and THB with a base year of Jan 2004.
Source: Bloomberg, Maybank FX Research & Strategy

USDTHB, USDMYR & USDSGD have the Highest Correlation with the USDCNY





Note: 120D Moving Correlation
Source: Bloomberg, Maybank FX Research & Strategy

G7 Global Overview

USD: Trade Tensions Take Centre Stage

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USD Index	94.31 (92.14)	92.20 (90.28)	90.79 (89.37)	90.18 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USD index was revised higher (stronger USD vs key G3 currencies) due to downward revisions to EUR (ECB rates to be on hold longer), GBP (lack of progress on Brexit and future relationship with EU) and JPY (policy divergence as BOJ remains on hold for 2018).

- USD likely to remain mixed for the remainder of 2018. Against the majors we expect to see a milder downtrend likely to remain in place for second half of 2018 but we do not rule out bouts of USD strength like what we had witnessed in the past few months. Against the emerging market and regional currencies we expect the dollar to remain strong as concerns that the ongoing trade tensions are starting to affect growth in China. If oil prices continue to rise and if there is a significant escalation of US-China trade tensions – we could see higher financial volatility and eventually some effects on global growth with impact on the USD upside being constrained and bond yields falling.

- However, if activity slows or labor market conditions weaken, we believe the Fed would be more likely to delay its normalization plans even if higher import prices boost short-term inflation outcomes. A more serious escalation that threatens the US recovery could lead to a pause in balance sheet normalization, though it is far too early to draw any such conclusion. For now, the committee sees fiscal stimulus as providing solid momentum in domestic activity, as well as a significant buffer against external shocks; we retain our view that the Fed will hike its policy rate one to two more times this year and four times next year.

- We do remain wary of more bouts of USD strength (as previously cautioned) that could emanate from a few scenarios - 1) trade war escalation which we think is more pronounced and sustained and will likely linger and get priced in particularly against emerging market currencies; 2) inflation pick up – price pressure is still subdued but sustained global recovery could stoke demand-pull inflation and a global bond rout; 3) markets to re-price a more aggressive tightening trajectory as the Fed becomes more hawkish under the new Chair Powell; 4) US fiscal and debt issues could lead to more issuance; 5) Italian political uncertainty affecting risk aversion or flight to quality flows into US and global AAA assets with better credit rating, supporting USD among others. These could in turn trigger another sell-off in global bonds and correction in riskier assets.

- However, despite the rise in US libor, widening of libor-OIS spread (partially attributable to surge in funding needs for US Treasury owing to Trump's fiscal measures) could potentially moderate when 1) US funding requirements slows and US Treasury receives tax receipts. This could lead to a less tight global funding market and typically weigh on the dollar; 2) The peak in earnings growth and over-shooting on the bond front could lead to some volatility in the equity market and eventually potentially lead to some moderation in any bond sell-off.

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

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

- To add further on the USD inverse relationship with global trade and economic growth is that a large share of international trade is transacted in USD even when the US itself is not the party to the transaction. This suggests that world trade volumes are driven in large part by USD. Appreciation in the USD crimps demand for US exports but also for all USD-denominated exports.
- Developments in US trade relations with China, Europe and NAFTA in coming months will be crucial. But it will be hard to forecast its schedule with certainty and its impact as the scenarios are multiple fold. In the meantime, markets are likely to price the trade war risk premium with greater certainty at the moment since June.

- Growth and Inflation Outlook: Gross domestic product increased at a 2% annualized rate (est. 2.2%), revised from previous est. of 2.2%. Consumer spending, biggest part of the economy, rose 0.9% (est. 1.0%), revised from 1%. Spending on services grew 1.5% (prev. est. 1.8%), while inventories and net exports subtracted from GDP (prev. reported as making small contributions). Investment in intellectual property jumped at an upwardly revised 13.2% pace, most since 3Q 1999

- The general picture of economic growth remains the same; downward revisions to private inventory investment, residential fixed investment, and exports were partly offset by an upward revision to nonresidential fixed investment. But US GDP growth slowed slightly more than initially thought in 1Q amid downward revisions to inventory investment and consumer spending, even as income tax cuts are likely to boost activity this year. There are signs GDP growth gathered momentum early in the second quarter, with solid consumer spending, business investment on equipment and industrial production in April. But the housing market appears to have taken a further step back. Market participants expect a $1.5 trillion income tax cut package, which came into effect in January, will spur faster economic growth this year and lift annual GDP growth close to the Trump administration's 3% target. However, the latest Conference Board's index of consumer confidence edged lower to 126.4 in June, from an upwardly revised 128.8 in May. The outturn was below our expectation of a modest improvement (129.0) and was driven primarily by a decline in consumers' expectations. The decline in June only suggests that consumers do not expect the economy gaining any further momentum in the near future. In all, consumers continue to view current economic conditions as favorable but are now likely questioning the sustainability of the current momentum six months out.

- The May CPI inflation rose in line with our expectations. Headline CPI rose 0.2% m/m and core CPI was up 0.2% m/m (0.171%). Headline CPI was supported by strong increases in energy prices while core inflation remains weighed by certain structural and industry-specific factors, particularly in non-food consumer items and autos. Core services inflation was in line with its recent trend and remains anchored by shelter inflation. While the top-line numbers were as we had expected, there was underlying volatility within the subcategories as gains in medical care commodities and new vehicle prices were largely offset by declines in airline fares and medical care services. Overall the May CPI report confirms our expectation of the underlying inflation trend: steady core services inflation and modest deflation in core goods. Looking further out, we expect fiscal stimulus to keep the US economy on an above-trend growth path, leading to increased resource utilization over time, which is likely to lead to a modest overshoot of inflation above the Fed's 2% target. Data on current PCE inflation and labor markets suggest the Fed has largely met its dual mandate. Yet, we do not view current inflation trends as likely to cause the Fed to move faster or alter its view that monetary policy should be normalized gradually. Even though current inflation is largely at target, many FOMC members view a modest overshoot of the 2.0% target as welcome, if not necessary, to support some firming in long-run inflation expectations above current levels. Were this to occur, committee members would likely feel more comfortable about the Fed meeting its inflation target on a sustainable basis.

- **Monetary Policy Forecast: We maintain our outlook that further progress toward the Fed's mandate will keep the FOMC on a path of gradual policy normalization. We expect the next 25bp increase in the target funds rate to occur as early as Sep with a total of 4 hikes this year.** Fed funds rate (FFR) was raised by +25bps to 1.50%-1.75% at the first FOMC meeting chaired by Jerome Powell in March 2018.

- The key takeaway from the 12-13 June 2018 FOMC meeting is Fed is bringing forward the rate hikes by shifting its guidance on the number of interest rate hikes for 2018-2020 to four this year, three next year and one in 2020 vs three each this year and next year and two in 2020.

This means the FFR is projected to increase by +100bps this year, +75bps next year and +25bps in 2020 vs previous guidance of +75bps each this year and next year and +50bps in 2020. But underlining the continued gradual interest rate normalization, the numbers and quantum of FFR hikes in 2018-2020 remain at eight and +200bps in total, on top of the five hikes totaling +125bps done in 2015-2017.

- The shift in the rate hike guidance reflects Fed's assessment of strong growth, tight labour market and inflation around its 2.0% target as the latest FOMC Statement said economic activity has been rising at "solid" rate (vs "moderate" in previous FOMC Statement), unemployment rate has "declined" ("stayed low" previously) and household spending has "picked up" ("moderated from its strong 4Q 2017 pace" previously) as well as the removal of "market-based measures of inflation compensation remain low" from the statement.

- Fed also revised upwards its 2018 growth forecast to 2.8% from 2.7% previously while maintaining the numbers for 2019 and 2020 at 2.4% and 2.0% respectively. Unemployment rate in 2018/2019/2020 are now expected to be lower at 3.6%/3.5%/3.5% vs 3.8%/3.6%/3.6% previously. Inflation rate will be around Fed's 2.0% target i.e. 2.1% p.a. in 2018-2020. With two totaling +50bps hikes already delivered, we expect the remaining two amounting to +50bps hikes to come at the 25-26 Sep 2018 and 18-19 Dec 2018 FOMC meetings.

- Meanwhile, Fed is also undertaking quantitative tightening via its balance sheet reduction which began in Oct 2017. As at 6 June 2018, Fed's balance sheet declined by –USD135.5b to USD4,366.8b from USD4,502.2b at end-Sep 2017. Over the same period, Fed's holdings of US Treasury securities fell –USD87.6b to USD,2377.9b from USD2,465.4b, while its holdings of agency debts and mortgage-backed securities dropped –USD35.9b to USD1,739.0b from USD1,774.9b. Based on a study by Atlanta Fed on "shadow" FFR, we estimated that that the previous balance sheet expansion via quantitative easing had the same effect of providing additional -360bps in equivalent FFR cuts, on top of the actual –500bps cuts in FFR. Therefore, current balance sheet reduction or quantitative tightening should have the effect of "shadow" FFR hikes on top of the actual FFR hikes so far.

- **Latest Fiscal and External Balance Outlook:** The "Tax Cuts and Jobs Act" (TCJA) was signed into law on Dec 22, 2017. Although the tax policy left out many controversial overhauls that have been put forth, the final reconciled bill between the House and the Senate still saw major reforms including corporate tax cuts to 21% from 35% and one-time tax repatriate of earnings and profits at 15.5% and 8% for reinvestments (further details are outlined in Appendix 1 at the end of this report). These tax reforms will have implications on broader economy, politics and the US Dollar.

- Briefly on the economic front, the TCJA is expected to increase US GDP by 0.8% in 2018, reduce marginal tax rates and increase personal consumption. Output and aggregate demand will be lifted, hence boosting government revenue, according to Tax Policy Center's (TPC) analysis on macroeconomic effects of tax reforms.

- On the tax reforms' implications on FX, it is not as clear cut. The one-time repatriation could lead to demand for USD. In the current episode that is unfolding, tax reforms is expected to widen US budget deficit to -5.4% of GDP (vs. -3.4% currently) while debt to GDP will rise to 97.5% of GDP (vs. 75% of GDP currently), according to Congressional Budget Office (CBO) estimates.

- And if history is of any guide, the current period of tax reforms (widening budget deficit and rising debt to GDP) is akin to expansionary fiscal policies and like previous periods, the USD should weaken.

- **Key domestic events and issues to watch in July 2018:** ISM Mfg (2 Jul); FOMC meeting minutes (6 Jul); Factory orders and Durable Goods Orders (3, 26 Jul), NFP (6 Jul); Trade balance (6 Jul); CPI (12 Jul); Retail Sales (16 Jul); GDP 2QA (27 Jul); Core PCE (31 Jul); PCE Deflator (31 Jul).

- **Technical Outlook:** USD extended its rebound for the third consecutive month for Jun. DXY tested fresh-2018 high of 95.53 (21 and 28 Jun) before easing off. Last seen at 94.80 levels. Bullish momentum on weekly chart remains intact but stochastics is in overbought conditions. This suggests there could be limited upside from current levels given relatively stretched conditions. Resistance seen at 95.50, 96 levels (50% fibo retracement of 2017 high to 2018 low). Support at 94, 93.10 and 92.40 levels. Bias to lean against strength ahead. It is worth taking stock of our technical call (in last month's FX Outlook) for DXY to start Jun on a softer note before rebounding into FoMC meeting in mid-Jun, the play did materialise with DXY easing to 93.2 before the move higher from mid-Jun.

EUR: Political Musical Chair Shifts to Germany

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
EURUSD	**1.1700** (1.1900)	**1.2000** (1.2200)	**1.2200** (1.2400)	**1.2300** (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View: We maintain a constructive outlook on the EUR into 4Q 2018 and beyond** on a combination of factors including: (1) "out-of-consensus" expectations that ECB may have to move earlier than expected to normalize monetary policy (possibly starting with deposit rate presently at -0.4%); (2) sustained signs of growth momentum in Europe, looking past transitory factors in 1Q; (3) inflation could remain supported or at risk of overshooting ECB's target due to energy prices and via imported price channel; (4) political risks to gradually recede. These factors formed the basis of our upward sloping trajectory over the next 12 months despite our move to calibrate the forecast levels lower to take into account recent market development including the high likelihood of trade war between US and EU (tit-for-tat responses), political stresses in Germany amid monetary policy divergence between Fed and ECB.

- That said in the near term, we hold to our view that uncertainties in the EU political space (this time the focus shifts to Germany) should not be underestimated and could continue to weigh on EUR. **We stick to our call that EUR could be at risk of trading lower towards 1.1450 or even 1.12 in the coming weeks. But maintain our bias to accumulate on dips.**

- With markets looking past Italy (after new government expressed commitment to stay in the Euro), political stress is now shifting to Germany.

  - Political issues in Germany with regards to migration (relates to coalition government divide over migrants/refugees) and Chancellor Merkel possibly at risk of losing powers (Merkel grand coalition government could be in trouble if CSU loses the election in Bavaria (October) or **Merkel dismisses Horst Seehofer as Interior Minister, also the leader of CSU or Seehofer resigns and coalition government loses a key partner) is a key source of volatility (and uncertainty) for EUR.**

  - According to local news report, Seehofer has threatened to order officials to reject certain asylum seekers at the German borders unless Merkel is able to agree to a deal with other EU members at the upcoming EU Summit (28-29 Jun). Failure to reach a deal would result in a meeting between CDU and CSU on 1 Jul on how to move forward. **Market talks of Interior Minister Seehofer possibly resigning and that could jeopardise the coalition partnership and weigh on EUR. A deal with EU could help to mitigate the downside pressure on the EUR.**

- **While the ECB is expected to keep monetary policy stance status quo at the upcoming Governing Council meeting (26 Jul), we see some chance that ECB may need to move earlier than expected** (possibly within the next quarter) should inflation and growth/activity data continues to hold up well. **We do not rule out the possibility that ECB could proceed with baby steps to normalize deposit rate first** (currently at -0.4%) at some stage possibly as early as 4Q 2018. Monetary policy can still be accommodative to support growth even with a modest increase of 10bps on deposit rate to -0.3% from current levels of -0.4%.

  - Inflation may still face upward pressures from energy prices and via import price channel given EUR's 7-8% depreciation over the past few months.

  - PMIs are already showing tentative signs of regaining momentum after the transitory slippages in 1Q.

- Taking stock of our last monthly outlook (spot ref then 1.16), we called for technical rebound in the EUR to 1.17 and shared that any rally may not be sustainable as markets shift into "sell on rally" mode on the back of heightened political stresses and deepening policy and data divergence, and we did not rule out a decline towards 1.1450. Price action in the month saw EUR rallied to a high of 1.1860 in mid-Jun before turning lower for second half of Jun. And was last seen at 1.1530 levels. We continue to highlight that immediate support is seen at 1.15 levels (interim double bottom from the lows in May and Jun) before 1.1450. Heightened uncertainty (or choppy trading) could be front-loaded in the first week of Jul given German political parties meeting on 1 Jul (Sun) if Merkel fails to get a deal at the Summit by 29 Jun. A threat to German coalition government could see EUR testing below 1.1450 levels.

- **Growth and Inflation Outlook: ECB projections for 2018 growth has been revised lower to 2.1%** (vs. 2.4% in Mar-2018 projection) while projections for 2019 and 2020 stay unchanged at 1.9% and 1.7%, respectively (as of last ECB macroeconomic projection in Jun 2018 report). Downward adjustments were made to private consumption and investments. Nonetheless ECB still expects growth to remain solid over the next few quarters, in line with elevated levels of business and consumer sentiment though real GDP is projected to trend gradually lower towards 1.7% in 2020 as tailwind gradually fades.

- 1Q final growth slowed to +0.4% (vs. +0.7% in 4Q) on sequential terms. On y/y terms, 1Q growth slowed to 2.5% (vs. 2.8% in 4Q). The **moderation was due to a few temporary factors** including cold weather conditions, influenza outbreak in Germany, Easter holidays and industrial strikes. There are also reasons to believe that the moderation was due to supply side constraints. ECB highlighted that capacity utilisation and backlogs/supply delivery times in the capital goods sector stand at all-time highs while in the construction sector, an increasing number of firms are indicating that a shortage of labour is limiting their production. Unemployment rate at 8.5% (Apr) is now at its lowest level since Dec-2008. Nonetheless, **Euro-area recovery continues with 20 consecutive quarters of growth. Recent PMI report for Jun showed manufacturing sector held up (55 vs. 55 expected) while services sector picked up pace (55.0 vs. 53.8 expected vs. 53.8 in Apr).**

- **As of the last ECB macroeconomic projection (Jun 2018), inflation is projected to inch higher to 1.7% for 2018 and 2019 from 1.4% (Mar projection). ECB's trajectory for inflation is expected to remain flat at 1.7% for forecast horizon from 2018 - 2020** as declining profile of energy inflation offsets a gradual strengthening in non-energy and food inflation.

- **Euro-area inflation jumped to** 1.9% y/y in May (vs. 1.3% in Apr) while core inflation also jumped to 1.1% (vs. 0.8% in Apr). The pace of move is the fastest in more than a year and current levels of inflation are also at fresh 2018 high. This reflects higher energy prices of late and validated our earlier call for inflation to go higher towards ECB's 2% target on ECB's monetary policy measures, continuing economic expansion and rising wage growth.

- **Monetary Policy Forecast: We expect ECB to keep monetary policy stance status quo at the upcoming Governing Council meeting (26 Jul),** following their recent move in Jun on timeline of APP reduction and forward guidance on rates. **While ECB may hope to keep rates unchanged for the next 12 months, we see risk that the ECB may need to move earlier than expected** (possibly within the next quarter) should (1) inflation data, in particular core CPI continues to surprise to the upside while (2) growth and activity data continues to hold up. With global oil production still constrained despite planned OPEC production increases, oil prices could still stay supported and that may tip EU inflation to overshoot ECB's inflation forecast in the near term. To add, recent political turmoil in Italy (though risks have receded) and Germany have depressed EUR FX. A weaker currency could result in higher prices via the import price channel. This may well add on to further upside pressure for EU CPI. **We do not rule out the possibility that ECB could proceed with baby steps to normalize deposit rate first** (currently at -0.4%) at some stage possibly as early as 4Q 2018.

- At the last ECB meeting (14 Jun), ECB announced that APP at monthly pace of €30 billion will continue till Sep 2018 and will be **reduced to €15 billion per month between Oct and Dec 2018 and then APP will end thereafter.** Policy rates (Main Refinancing operations, deposit facility and marginal lending facility were kept on hold at 0%, -0.4% and 0.25%, respectively). ECB added that rates will be kept at current levels at least through the summer of 2019 (Jun – Sep) depending on incoming data.

- **Latest Fiscal and External Balance Outlook:** Euro area's current account surplus narrowed to 10-month low of EUR28.4bn in Apr (vs. EUR32.8bn in Mar). Surplus on trade narrowed to EUR21bn (vs. EUR30.3bn) while surpluses on services rose modestly to EUR9.6 bn (vs. EUR9.4bn). Current account surplus to GDP was last seen at 3.7%.

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

- **Key domestic events and issues to watch:** Jun Mfg PMI, May PPI and unemployment rate (2 Jul); May retail sales (3 Jul); Jun services PMI (4 Jul); ZEW Jul expectations (10 Jul); May IP (12 Jul); May trade (16 Jul); Jun CPI (18 Jul); May current account (20 Jul); Jul prelim PMIs (24 Jul); ECB meeting (26 Jul); Jul CPI estimates and 2Q GDP (31 Jul).

- **Technical Outlook:** Taking stock of our technical call (in last month's FX Outlook) – we share that EUR could rebound and a break above area of resistance at 1.1690 - 1.1720 puts next level at 1.1790 (21 DMA). EUR subsequently traded a high of 1.1851 (mid-Jun) before trading down to a low of 1.1509 (21 Jun). Pair was last seen at 1.1655 levels. Price action suggests an interim bottom may have been formed around 1.15 levels. Bearish momentum on weekly chart though remains intact; stochastics shows signs of turning from oversold conditions. Rebound risk not ruled out. Bias to buy on dips. Resistance at 1.1760 (23.6% fibo retracement of 2018 high to Jun low) and 1.1850, 1.1910. Area of support remains at 1.1450 – 1.1500.

GBP: Interim Weakness but Opportunity to Buy on Dips

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
GBPUSD	**1.3400** (1.3800)	**1.3800** (1.4000)	**1.4000** (1.4200)	**1.4200** (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** GBP softness could still persist in the interim amid ongoing Brexit uncertainties, policy divergence between Fed and BoE as well as softer risk sentiment arising out of trade war concerns between US and EU/China. GBP weakness could be further amplified by USD strength. We revise our GBP forecasts lower but maintain the upward trajectory over the forecast horizon. In the interim, we do not rule out another attempt towards 1.30 levels (current spot ref at 1.3210 at time of writing). But expect dips towards 1.30 to be an opportunity to buy into.

- Upcoming data could show further improvement following weather-related slowdown in 1Q and this could add to bets that BoE could potentially raise rate at the upcoming MPC meeting on 2 Aug. Markets are now re-pricing the probability of the BoE rate hike as soon as in Aug (71% vs. under 50% in mid-Jun). Potential data improvement and renewed rate hike bets should support the case to buy GBP on dips.

- Into the medium term, we maintain our bias that GBP could trade higher from current levels of 1.32. GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40). The 20% or so depreciation (from Jun to Oct 2016) should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We hold to our belief that UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term).

  – 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.

- **Downside Risks to Our View: GBP could be vulnerable to renewed downside pressures:** (1) if trade war tensions between US and EU/China further escalates - this could derail growth momentum, dampen sentiment and business/investor confidence; (2) ongoing brexit uncertainties (with regards to future relationship with EU) to prolong; (3) renewed leadership pressure on PM May; (4) slowing economic data including the deceleration in wage growth and falling inflation in UK; (5) BoE MPC to defer tightening to a later date.

- **Growth and Inflation Outlook: 1Q GDP growth slowed to weakest level since 2012** at +0.1% q/q (vs. +0.4% prior). The slowdown can be attributed to shrinking business investments (-0.2%) while household spending recorded its weakest print in more than 3 years (at +0.2%). In terms of sector, manufacturing, services sectors slowed while construction output shrank. These data continued to validate our earlier caution that growth momentum was decelerating.

- But there are signs that momentum could pick up again and this should bode well for 2Q GDP (to be released on 29 Jun).

  - BoE had weighed in to say that slowdown in 1Q has been severely exaggerated by the bad weather disrupting shoppers and construction work.

  - If this is true, we could possibly see growth and activity rebounding in 2Q, and this should bring back market expectations for BoE rate hike possibly as early as in Aug.

  - To be sure, retail sales for Apr (+1.8% m/m) and May (+1.3% m/m) surprised to the upside. On y/y terms, retail sales rose to +3.9% in May (up from +1.4% in Apr). To add, retail sales account for about 1/5 of UK GDP and this rebound should be supportive of 2Q GDP.

  - Services PMI extended its rebound in May (54.0 vs. 52.8 in Apr), recovering from its recent low in May while manufacturing PMI also surprised to the upside (54.4 vs. 53.9 in Apr). Construction PMI held steady in May (unchanged at 52.5 from Apr), supported by commercial construction segment while residential and civil engineering segments saw a moderation.

  - Labor market has also continued to tighten with unemployment rate falling to more than 4-decades low of 4.2%. There are also signs that wage growth may gain traction amid tightness of labor market conditions and this could generate domestic price pressures. Wage-squeeze conditions for UK consumer could ease and that should support consumption going forward.

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

- **UK headline inflation for May held steady at 1y low of 2.4% y/y.** Markets were expecting a slight rebound to +2.6% owing to oil price increases. But that did not materialize as main drags came from falling costs of computer games, sweets, chocolates which helped to offset the rising cost of petrol. Despite the overall slowdown in CPI, inflation at current levels remains well above BoE's target of 2%. The increase in oil prices, pick-up in activities and tightness of labor market (likely to generate price pressures) should feed through to inflation at some stage. Our internal forecast on UK inflation trajectory suggests that inflation may have peaked at 3% in 4Q 2017 and is slowly easing towards 2% in 1Q 2019. Core inflation also held steady at 2.1% y/y in May.

- **Monetary Policy Forecast: There is no scheduled MPC meeting in Jul and the next meeting is scheduled on 2 Aug.** Markets are now re-pricing the odds of a 25bps rate hike to 0.75%. OIS-futures implied a 71% chance of rate hike in Aug (up from under 50% in mid-Jun). **This validates our out-of-consensus call for BoE to raise rate at the August MPC meeting as growth momentum remains intact (barring weather-related disruption to 1Q activity) while labor market remains tight.** There are however factors that could negate rate hike motivations including ongoing trade war tensions between US and EU/China that could derail growth momentum, sentiment and business/investor confidence, ongoing brexit uncertainties and tentative signs of deceleration in wage growth and falling inflation in UK. The latter could defer MPC's decision to tighten to a later date, possibly in Nov-2018.

- The last BoE meeting (21 Jun) was inclined towards the hawkish camp. MPC voted 6-3 to keep policy rate on hold at 0.5% (a shift from 7-2). In a surprising twist, Chief Economist Haldane was the latest to join the dissenters (McCafferty and Saunders). The other major development was a unanimous decision that the size of BoE balance sheet may be reduced when policy rates reached 1.5%, down from previous forward guidance of 2%. In a nod towards the Brexiteers, BoE Carney also said that banks in the UK are resilient enough for a disorderly Brexit at his Mansion House Speech. To add, it is worth noting that BoE's forecasts assume a "smooth" transition to a new Brexit relationship. That suggests the risk of BoE keeping rates on hold should brexit transition proves to be less "smooth" than expected.

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

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

- **Key domestic events and issues to watch:** Jun Mfg PMI (2 Jul); Jun Construction PMI (3 Jul); Jun services PMI (4 Jul); May trade, IP, construction output (10 Jul); May labor report (17 Jul); Jun inflation (18 Jul); Jun retail sales (19 Jul); Jun public finances (20 Jul).

- **Technical Outlook:** GBP's decline continued for a third back to back month. Pair traded a low of 1.3050 (28 Jun) before the modest rebound. Last seen at 1.3110 levels. Bearish momentum on weekly chart remains intact while stochastics is in oversold conditions. We hold to our bias that downside from here could be sticky and limited towards 1.30, 1.2960 levels. May see a rebound towards 1.3290, 1.3360.

AUD: Hammered by Trade Wars

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
AUDUSD	0.74 (0.78)	0.75 (0.80)	0.78 (0.80)	0.80 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** AUD was one of the worst hit by trade war concerns given its exposure to China and its increasing reliance on trade. Copper which had underpinned the currency for the first half of this month gave up gains as investors become increasingly concerned on the US-China trade friction. Risk appetite dried up, also not helping AUD in the least and with Australia's inflation still subdued, monetary policy divergence vis-à-vis the Fed also weigh on the AUD. We refer to the technical chart. Key support level is seen around 0.7340 and a break there could see 0.72. There are plenty of downside risks to the AUD at this point but we also would like to take note of rebound risks should trade tensions between the US and China ease. Rebounds to meet resistance at 0.7480 before the 0.76.

- We have changed our bullish view on the AUD to being cautious as the US-China trade spat diminished the likelihood of any rate hike by the RBA this year. While we are sure that China's slowdown will not exacerbate and any improvement in the domestic data of China is AUD positive, the antipode is still very susceptible to risk sentiment and there are plenty of risk events ahead apart from a potential escalation in the US-China trade war, the US yield inversion that could trigger some concerns on potential US recession, possible political risks that lead into the 2019 election. The next Federal election to elect members of the 46th Parliament of Australia will be held between 4 Aug 2018-18 May 2019. We also do not rule out any upside surprise to the inflation print out this coming month.

- Into the next year, when we are past current risks environment, we see inflation heading higher. With domestic economic restructuring making more progress, we also envisage more room for RBA to hike rates (possibly in Feb). That could mean that AUD recovery could gain traction as early as 4Q of this year.

- **Growth and Inflation Outlook:** The last month ended with a disappointing CAPEX print for 1Q though the trend volume estimate continues to rise 0.5% in the Mar quarter 2018. Trend volume for equipment, plant and machinery rose 1.9%, offsetting the decline in the trend volume estimate for buildings and structures. Although the print was a downside surprise, capex is on a mild recovery trend. Capacity utilization rate is still high for most sectors relative to historical data, notwithstanding the ticks lower for May. In contrast, retail sales in Apr at 0.4%m/m was above the expected 0.3%. That was a positive indicator for household consumption. 1Q growth also surprised to the upside after a narrower current account deficit was released for the month. The stronger net exports boosted growth momentum. This is also a reason why a trade war could affect AUD so much at this time.

- Domestic demand is not deteriorating. As we have noted before, the rebates for lower to middle income households that came in the federal budget could support private consumption. The passage of the personal income tax cuts recently at the parliament could also support household income and growth momentum for Australia.

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

- **Monetary Policy Forecast:** RBA is less likely to signal a rate hike that before given the recent escalation in trade tensions that could crimp on growth for the Australian economy. The last SoMP released in May included a focus study on trade protectionism measures, highlighting that a scenario published by the IMF found that if all countries raise tariff and non-tariff barriers such that world import prices increase by 10%, over the long run, global imports and export would be 16% lower, output would be 2% lower and investment would be 3% lower. A cheaper AUD is still a more favourable one for growth. Probability of a rate hike in May as indicated by the OIS, has fallen from 58% to 33%. Monetary policy divergence could continue to weigh on the AUDUSD. We no longer look for RBA to hike until early next year (still out of consensus) possibly in Feb when the SoMP will be out. We anticipate inflation data could spur AUD bids well before the event, possibly at year end.

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

- Ahead of the Federal election that could come as early as 4 Aug 2018 (but more likely early next year), Turnbull managed to pass his A$144bn tax-relief package. On the other hand, its plan to lower corporate tax rate to 25% for all businesses lacks support to pass Senate according to the Finance Minister (Mathias Cormann).

- **Key domestic events and issues to watch:** Building approvals due on 3rd Jul along with RBA cash decision; trade data and retail sales; foreign reserves on 6th; NAB business survey on 10th; home loans on 11th; RBA July meeting minutes on the 7th; Labour report on 19th; 2Q CPI on 25th; PPI on 27th; building approvals (Jun);

- **Technical Outlook:** AUDUSD has been testing the 0.7340 for a couple of sessions and momentum indicators are slightly bearish. A break of the 0.7340 could open the way towards 0.72. There are little signs of a reversal except for the stochs that have been near oversold conditions for a while now.

NZD: Grounded

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
NZDUSD	**0.6700** (0.7300)	**0.7000** (0.7400)	**0.7100** (0.7500)	**0.7200** (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Taking stock of price action in the month of June, NZD traded a high of 0.7060 in early part of June before trading lower to 0.6820 levels (at time of writing). The moves have been largely confined to the range and bias we called for in the last monthly outlook - *consolidative play for NZD in the range of 0.6850 - 0.71 for the following few weeks as external factors such as Fed meeting in Jun, Italian political mess and agri-commodity prices will play a dominant role in the volatility of the NZD*. Currency weakness was exacerbated by sharp decline in activity outlook and business confidence data (27 Jun) and RBNZ's reiteration that the next RBNZ move can be a hike or cut (last RBNZ MPC statement on 28 Jun). We calibrate our forecast lower taking into consideration recent development including escalating trade tensions between US and China/Europe as well as growing divergence in monetary policies (latest statement raises the risk of RBNZ cut though our baseline remains for a hold beyond the next 6 months).

- Looking ahead, there is little catalyst for Kiwi upside as monetary policy divergence between Fed and RBNZ weighs on NZD while trade war tensions between US and Europe/China dampens risk sentiment. On the other hand, potentially brighter outlook for dairy sector in coming months could be supportive of NZD (given than dairy sector generates more than 7% of NZ GDP).

  – Fonterra projected a continued positive global supply and demand picture and that led to strong forecast in farmgate milk prices. It sees strong demand from China and for other dairy-related products including butter. Fonterra's forecast earnings per share for 2019 financial year – to be announced in Jul - will be closely monitored. Higher print could negate some NZD downside pressure.

- Little expectation for RBNZ rate hike this year vs. quicker pace of rate increases in US still suggests growing policy divergence between RBNZ and Fed could stay on. This would fuel the persistence of a negative carry environment (10Y NZ-UST yield differentials now at -4bps) and cap gains in the NZD.

- As such we expect consolidative play to continue but at a lower range of 0.67 – 0.70 for the next few weeks. Key data to look out for is NZ CPI on 17 Jul. A slower than 4Q print of 0.5% (q/q terms or 1.1% y/y) and/or softer Fonterra's EPS projection could pose downside risk to NZD.

- **Growth and Inflation Outlook: Growth momentum in NZ moderated for 1Q** (0.5% q/q vs 0.6% prior). This was due to infrastructure construction as reconstruction efforts in the aftermath of Kaikoura earthquake eases while most other sectors of the economy held up well.

- Growth for 2018 is likely to continue at current pace of around 3%, supported by net immigration, fiscal stimulus amid accommodative monetary policy. Though manufacturing PMI moderated to 54.5 in May (vs. record high of 59.1 in prior month), the print still indicates expansionary territory while services PMI showed that the sector expanded at a quicker pace in May (57.3 vs. 56.4 in Apr) owing to new orders. Services sector (makes up about 2/3 of GDP) is expected to remain one of the growth engines.

- The last quarterly Monetary Policy Statement on May-2018 noted that NZ economy is projected to continue growing at an average of 3.1% over the next 3 years. Above-trend pace of growth is expected to be strong enough to generate an increase in capacity pressure and lift inflation around the midpoint of the RBNZ target range of 1 – 3% over the medium term.

- In the last MPS on 10th May, RBNZ lowered inflation forecasts and predicted that inflation won't reach the 2% midpoint of its 1 – 3% target range until 4Q 2020 (vs. 3Q 2020 in prior projection). It also expects inflation to be lower than projected in the Feb MPS, reflecting a weaker outlook for tradables inflation. Our internal projection shows inflation could trend lower towards RBNZ lower bound of its range at 1% in mid-2018 before rising towards RBNZ's median target of 2% in early 2019. We believe potential fiscal impulse and proposed minimum wage increase (minimum wage to be raised to NZ$20/hour by 2020; and to NZ$16.50 by Apr-2018) could support consumer spending and result in faster pick-up in inflation.

- **2Q CPI is scheduled for release on 17 Jul.** 1Q CPI slowed to 18-month low of 1.1% y/y (vs. 1.6% in the last quarter). This comes close to the lower bound of RBNZ's inflation target range of 1 - 3%. Moderation in CPI was due to decline in education cost after government's decision to make the first year of tertiary education free while house construction prices rose at the smallest magnitude in

7 years. Breaking it down by tradables and non-tradable inflation, tradable prices fell 0.4% y/y due to airfares and appliances while non-tradable prices rose 2.3% y/y (due to rent and tobacco, the latter due to government imposition of tobacco taxes). The divergence between non-tradable and tradables suggests that early appreciation in NZD made imports cheaper.

- **Monetary Policy Forecast:** There is no scheduled meeting in Jul and the next MPC meeting is on 9 Aug. We expect RBNZ maintain OCR on hold at 1.75% at its next meeting amid softer inflation outlook, signs of moderation in global activity and ongoing stresses in Italy and EM assets. We were initially expecting RBNZ to possibly tighten rates as early as in 2H 2018 but given the recent comments from RBNZ Governor Orr (in May and Jun), they seem to suggest that **easy monetary conditions could stay on for longer**. We **hold to our deferred bias (first mentioned in out Jun FX Outlook) that rate hike would come to a later stage (some time in 2Q-3Q 2019).** We still expect inflation to pick up, owing to fiscal impulse, minimum wage increase but this may come later.

- At the last MPC meeting (28 Jun), the OCR was kept on hold at 1.75% as widely expected. **Accompanying statement was interpreted as slightly dovish though it is not much of a shift in bias from its last statement in May (**which said "OCR will remain at 1.75% for some time to come…the direction of our next move is equally balanced, up or down…only time and events will tell"). The current one said that *the Official Cash Rate (OCR) will remain at 1.75 percent for now. However, we are* ***well positioned to manage change in either direction - up or down - as necessary*****. This further reinforced the variability on the direction of RBNZ moves, which implied that the next move could even be a cut if economic conditions worsened.**

  - The last quarterly MPS in May pushed back its forecast for inflation to meet target in 4Q 2020, from 3Q 2020 prior.

  - And we think it is worth reiterating that RBNZ's Orr also said that move lower in NZD after May's RBNZ meeting was "a good thing". We think this could be taken as a passive aggressive hint that a softer Kiwi may be in Orr's preference.

- **Latest Fiscal and External Balance Outlook:** NZ government's operating surplus continues to surprise to the upside on higher than expected tax revenue. Operating Surplus before gains and losses (OBEGAL) was a surplus of $3.41bn in the 10 months ended Apr (vs. 3.25bn previously projected). Finance Minister Robertson forecasted a NZ$3bn budget surplus this year and possibly rising to NZ$7bn in 2020. Net debt at $62.5bn ($229m below forecast) and at 22.1% of GDP. It is projected to fall to 20.8% of GDP for the full year.

- NZ unadjusted current account turned to surplus in 1Q ($182m vs. deficit of -27.5bn in 4Q), helped by services balance as tourism receipts remain robust. In seasonally adjusted terms, annual deficit widened to -2.8% of GDP, driven by goods balance on higher import demand and higher oil prices while exports was lower amid softer dairy prices.

- **Key domestic events and issues to watch:** Food prices (12 Jul); Jun Mfg PMI (13 Jul); Services PMI (16 Jul); 2Q CPI (17 Jul); Jun trade (25 Jul); Jul Activity outlook (31 Jul). GDT trade auctions take place on 3 and 17 Jul.

  Technical Outlook: NZD rose in early part of Jun but gains were more than reversed into later part of the month. Pair was last seen at 0.6770 levels. Bearish momentum on weekly and daily chart remains intact but stochastics is in oversold conditions. Cautious of rebound risks but trend and bias remains for softer Kiwi. Look out for consolidative play in 0.67 – 0.69 range for the month ahead.

JPY: Safe Haven Demand Supportive

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDJPY	109.00 (106.00)	108.00 (104.00)	107.00 (104.00)	107.00 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** JPY faced headwinds for most of Jun that weighed on the currency. Monetary policy divergence between Japan and the US, lifted UST yields higher, widening the yield differentials between 10Y UST and JGB has put downside pressure on the JPY. This has dragged the JPY lower towards the 111-levels as a result. Even rising Sino-US trade tensions that had sparked a rise in global risk aversion and triggered an increase in demand for safe haven assets including the JPY has not been able to fully mitigate the impact from widening yield differentials. This has led the JPY to hover in a tight range within 109.20-110.90 in Jun, which is above our previous forecast of 108.50 for 2Q. Consequently, we have revised our USDJPY forecast higher but maintain the pair's downward trajectory.

- Concerns that the Fed could hike interest rates more rapidly in 2018 as the BOJ remains on hold have re-focused attention on the yield differentials between UST and JGB. Widening yield differentials between UST and JGB tends to weaken the JPY as JGBs are sold off in favour of USTs. This has led to a more pronounced weakness in the JPY than what we had expected. At the same time, broad USD strength in Jun has put further upside pressure on the USDJPY, keeping the pair elevated above the 110-levels.

- Market positioning appears to be supportive of the USDJPY at higher levels. Recent CFTC data showed investors are now betting on further USD strength ahead while positioning for JPY weakness due to policy divergence between Japan and the US. Net short-JPY positions have increased to 35562 contracts in the week of 19 Jun compared to just 1405 contracts at the start of the month. Long-JPY bets have been reduced by investors with 46565 contracts in place for the week of 19 Jun, a reduction from 57349 in the week of 1 Jun. Short-JPY positions though increased with 82127 contracts purchased compared to 58754 contracts in the previous week.

- In the near term, the imposition of tit-for-tat tariffs by US and China on each other effective 6 Jul should they fail to reach a trade agreement should trigger risk-off concerns and spur demand for safe-haven assets including the JPY. Uncertainty in trade policy within the Trump administration should keep trade concerns at the forefront in Jul. We should see increased risk-proxy plays that could put downside pressure on the USDJPY. At the same time, we could see the USDJPY lower as Jul, like Jun, tends to be a seasonally strong month for the JPY. There is thus the potential for the USDJPY to move lower in Jul from current levels.

- Domestic political risk could see added downside pressure on the USDJPY in 3Q. The ruling party is set to elect a President to lead the party in Sep. In normal situation, PM Abe would be re-elected unopposed. However, simmering domestic political scandal surrounding PM Abe that has rocked support for his government has weighed on support for his cabinet. Further slippages in support could embolden a challenge to PM Abe’s party leadership in Sep. A loss could see a pullback in current easing policy and slow institutional and economic reforms even further. This could spark risk aversion and weigh on the USDJPY in 3Q.

- In the medium term, speculation over BOJ exit strategy will persist even as BOJ reiterates its powerful easing policy. The lack of inflationary traction and its divergence from its G7, who are either already tightening the screw on policy or on the verge of doing so, is unlikely to stop market speculation about such an exit strategy for the BOJ. Such speculation could encourage JPY-bulls and weigh on the USDJPY.

- Given recent market developments, we have adjusted our USDJPY forecast accordingly. We now expect the USDJPY to move lower on a more gradual trajectory than before as the pair remains supported by yield differentials. We look for the pair to end-3Q around 109 (from 106 previously) and then to end the year around 108 (from 104 previously). Thereafter, the USDJPY is expected to hover around the 107 levels in both 1Q- and 2Q-2019.

- **Growth and Inflation Outlook:** Economic growth momentum stalled after eighth consecutive quarters of expansion. Final estimates for 1Q 2018 GDP showed the economy declining by 0.2% q/q or 0.6% annualised, unchanged from the preliminary estimates. This was due to the revised increase in capital spending (of +0.3% from -0.1% previously) being completely offset by the smaller decline in private residential investment (-1.8% vs. -2.1% previously). We do not expect this correction to persist. This is because private consumption could pick up as the weather improved unlike in 1Q. At the same time, export continues to expand by a healthy 8.1% y/y in May, accelerating from 7.8% in Apr, helped by softer JPY. More importantly, support from the government’s FY2017 supplementary spending package of around JPY2tn as well as preparations in the run-up to the 2020 Olympics in

Tokyo should bolster economic growth for the whole of 2018. Broadly though, the economic outlook in 2018 remains mixed with the economy unlikely to outperform in the quarters ahead. The BOJ expects the economy to expand by 1.6% and 0.8% in FY2018 and FY2019 respectively. Any revisions to the economic outlook will be revealed in Outlook Report due to be release together with the monetary policy statement on 31 Jul.

- There are still no signs of any significant pick-up in inflationary pressures. Headline and core inflation rose 0.6% and 0.7% y/y respectively in May, the same pace for both as in Apr. More importantly, core-core inflation (headline less fresh food & energy) – the BOJ's preferred gauge of inflation - failed to show signs of acceleration, rising by just 0.3% y/y in May, the third month of deceleration. The lack of traction in inflation makes achieving the BOJ's 2% inflation target a challenge. There is some hope that inflation could pick-up ahead. Crude oil prices remain on the rise, while weakness in the JPY could lift import prices and these should put upside pressure on consumer prices. Still, the recently released summary of opinion for its 14-15 Jun policy meeting showed that members of the BOJ monetary policy board do not seem overly optimistic on the inflation outlook. The broad view appears to be that persistent powering easing policy is needed to achieve the inflation target. The BOJ expects core inflation to come in at 1.3% in 2018 and at 1.8% (excluding the effects of the consumption tax hike) in FY2019 and FY2020 for now. The BOJ will update its inflation projection in its Outlook Report due at its Jul policy meeting.

- **Monetary Policy Forecast:** There were no surprises from the BOJ which left its policy stance unchanged at its 14-15 Jun policy meeting. The central bank kept its balance (short-term) rate and its 10Y JGB yield target unchanged at -0.1% and around 0% respectively. It also maintained the pace of asset purchases at JPY80tn annually even though this measure is no longer central to its "QQE with Yield Curve Control" policy regime. The decision was not unanimous though with Board member Goushi Kataoka dissenting yet again, calling for additional stimulus to lift inflation, especially in wake of the softer BOJ assessment of inflation.

- At the press conference post-MPC announcement, the focus was not on inflation but BOJ's plans for exit from its powerful easing. BOJ Governor Kuroda reiterated that it was premature to discuss any exit from stimulus. Still, this is unlikely to sway markets as speculation about an exit strategy is likely to continue. This speculation about an exit strategy is likely to curb attempts by the JPY-bears to push the JPY lower beyond the 110-levels.

- **Latest Fiscal and External Balance Outlook:** As we had cautioned last month, the cabinet has approved a plan that delays a primary balance surplus by five years to 2025. At the same time, the cabinet agreed to drop a JPY500bn cap on annual increases in social spending. In addition, the government put in place three additional fiscal goals to achieve by the time it crafts its next mid-term plan in 2021, namely (1) halving the primary balance deficit from its 2017 levels; (2) reducing the debt to 180-185% of GDP; and (3) cutting the budget deficit to within 3% of GDP. The plan also affirms that the 2% point increase in the sales tax in Oct 2019 to 10% will proceed.

- The current account (CA) surplus narrowed to JPY1.85tn in Apr from JPY3.12tn in Mar as the surplus in goods and services slipped to just JPY0.07tn in Apr compared to JPY1.19tn in Mar as well as the smaller primary income surplus of JPY1.94tn in Apr vs. JPY2.11tn in Mar. The financial account surplus came in at just JPY0.43tn in Apr, narrowing significantly from JPY4.61tn in Mar as portfolio investment outflows of JP1.99tn (Mar: +JPY4.61tn) in Feb that more than mitigated gains in “other investment” of JPY1.36tn (vs. -JPY0.91tn in Mar). Consequently, the overall balance of payments (BoP) surplus narrowed to JPY0.85tn in Apr from JPY9.23tn in Mar.

- **Key domestic events and issues to watch:** Tankan Survey Results for 2Q is on tap 2 Jul. BOJ meets on 30-31 Jul to decide on monetary policy and will also update its inflation and economic growth projection in its Outlook Report. Before that, we have BOJ Harada and Masai speaking on 4 and 5 Jul respectively. JGB auctions in Jul: 10-year (3 Jul), 30-year (5 Jul), 5-year (10 Jul), 1-year (19 Jul) and 20-year (12 Jul).

- **Technical Outlook:** USDJPY traded higher for the month of Jun. Last seen at 110.70 levels. Weekly momentum remains bullish while stochastics is rising into near overbought conditions. Pair may once again test 111.40 (May high), 111.80 levels. Support at 110, 109 levels.

RMB: Market Forces Take Over

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDCNY	6.75 (6.35)	6.72 (6.10)	6.65 (5.90)	6.62 (--)
USDCNH	6.75 (6.35)	6.72 (6.10)	6.65 (5.90)	6.62 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** We noticed that the daily closing price of USDCNY has an increasing deviation from the fixing for the day in the past two weeks. This suggests that market forces could be lifting the USDCNH and concomitantly the USDCNY with increasing momentum. There seems to be a growing consensus that PBoC allows market forces to determine the RMB. FX intervention and retracements should not be ruled out but risks in our view are still to the downside vs. the USD.

- PBoC cut the reserve requirement ratio for qualified banks by 0.5ppts with effect on 5 Jul. The ratio cut for five state-owned banks and 12 joint-stock commercial banks will release about CNY500bn yuan for debt-to-equity projects according to a statement on the PBoC website.

The RRR cut for other banks include urban, rural commercial banks and foreign banks is meant to release CNY200bn to provide credit support for micro and small-sized companies. The USDCNY move (lower) actually came days before the announcement when the state council had hinted strongly of an upcoming RRR cut. The trade war has triggered a strong sell-off in the domestic stock markets and since 20 Jun, the USDCNY fixing has been consistently below our fixing model projection. This suggests that despite all the talks about using the RMB as a tool for trade war, the central bank does not intend to weaken it deliberately to clawback exports competitiveness. Previous RMB devaluation was followed by sharp depreciation pressure on the RMB and capital flights that PBoC fought to stabilize and curb. That had cost U$1trn from its FX reserves. China had made significant progress to improve investors' confidence in its financial markets (A-shares gaining entry into MSCI EM and foreign institutional investors diversifying into China's bond markets) and to "open up its capital markets". A "defensive devaluation", at this point, could be even costlier than before. With a lot of uncertainty on trade and domestic demand, allowing market forces to drive CNY at least ensures transparency on the part of RMB management by the PBoC.

- The trade war has come at a time when domestic demand is weakening amid deleveraging efforts and that would leave RMB fundamentally weaker, particularly after PBoC Governor Yi Gang has vowed to use policy "comprehensively". We take that as a sign that monetary policy stance has tilted towards growth cushioning. In the event that China and the US impose the trade tariffs that they have threatened to take effect on 6 Jul, another RRR cut in Oct cannot be ruled out. While PBoC could continue to slow the depreciation in the RMB, USDCNY is still more vulnerable to the upside and we look at a possible test of 6.70 in the near future and USDCNY to head towards 6.75 by the end of 3Q before tapering off into the last quarter of the year as economic data show improvement and trade tensions ease.

- **Growth and inflation outlook**: Economic data came in mixed with purchasing managers still reporting expansion in the manufacturing sector, exports decelerating in growth, activity slowing on almost all fronts and inflation rather subdued. The NBS released a PMI-mfg headline that looked pretty good at 56.7 (vs. the previous 53.0) but the breakdown revealed that while managers in the large and medium enterprises are saw expansion in output. Those in small enterprises reported contraction in production for May. The fall in industrial production for the month shows that the PMI-mfg prints have not been reliable leading indicators of production.

- The fall in aggregate financing and credit growth in general also underscores the pressure that banks and corporates are under as debt financing becomes increasingly expensive in a backdrop of plenty of corporate bond defaults. While credit growth in local currency steadies around 10% and credit growth in foreign exchange in double digit contraction, net corporate bond financing is rising. Retail sales dropped to 8.5%y/y in May vs. previous 9.4%. Fixed assets investment (ex-rural) also decelerated significantly to just 6.1%y/y from previous 7.0%. The activity data release came just after the FOMC meeting. PBoC did not hike in step with the Fed. In addition, PBoC provided more credit support via the MLF. The arrival of the trade war also likely prompted the central bank to cut RRR earlier than planned as liquidity support was deemed urgently needed to quell the panic in the stock markets. In addition, the Ministry of Finance also indicated that there will be "accelerated fiscal spending" to support stable economic growth. Hence, while the slowdown looks to have occurred, the slowdown could also be slowing.

- CPI held steadied at 1.8%y/y for May as the deflation in meat prices offset the rise in cost of eggs and vegetables. We see upside pressure should the US and China implement the tariffs on each other. PPI rose unexpectedly to 4.1%y/y from previous 3.4%, buoyed by the rise in energy prices and other raw materials. PPI could continue to remain a tad lofty on supported crude price action but trade tensions could affect commodities enough to bring down commodity prices and weigh on PPI.
- **Monetary Policy Forecast:** The RRR cut that is meant to take effect on 5 Jul is targeted at companies that use debt-to-equity swaps and smaller companies that do not have access to credit. These companies that needed to convert the debt to equities are typically debt laden companies that are SoE in the steel, cement and coal industries. PBoC had said that the liquidity from the required reserve cut is not meant to flow to "zombie companies" and they are targeted. It is meant to be a structural tweak but liquidity support nonetheless.
- That said, we do not think that rates will be brought down significantly to ensure that deleveraging efforts in so far will not come to waste. Rates are likely to remain supported but RMB will be allowed to weaken amid external headwinds and domestic challenges. MLF could be tapped on more frequently but we do not rule out more RRR cuts to support the equities and the economy. However, the latter should not be used frequently. Markets speculation of another RRR cut in Oct is possible as China and the US are increasingly likely to impose tariffs on 6 Jul. With those risks ahead, expect pressure on RMB to increase vs. the USD.
- **Latest Fiscal and External Balance Outlook:** China had set out a target earlier this year, to reduce its budget deficit target from 3% of GDP to 2.6%, lower than speculated 2.9%.
- The MoF indicated recently that there will be accelerated fiscal spending to support stable economic growth. High quality economic development had enabled fiscal revenue growth in the first five months of the year. This suggests that they are still ensuring that budget deficit is kept on target.
- Foreign reserves slipped to U$3.11trn from previous U$3.12trn. After taking into account valuation impact, forex reserves actually saw small actual gains instead of losses. This suggests that PBoC had not used much ammunition to defend the CNY as of May and any outflows thus far are not concerning as yet.
- **Key domestic events and issues to watch:** NBS PMI numbers for May due on 30th Jun, RCEP meeting on 1st Jul; Caixin PMI is due on the 2nd Jul; FX Reserves on the 9th; inflation on the 10th; Money supply, new

yuan loans, aggregate financing on 10-15th; trade data on the 13th; surveyed jobless rate, activity data including 2Q GDP on the 16th; new home prices on the 15th; FX net settlement (clients) on the 19h; industrial profits on the 27th.

- **Technical Outlook:** The momentum indicators on the monthly chart have been warning of bullish extensions. The 6.6660 marks the next resistnace level and we do not rule out further extension beyond the 6.70 (61.8% Fibonacci retracement of the 2016 high to 2018 low. 6.81 marks the next level to watch but we think gains could slow then. Support is seen at 6.6120 (50%). Risks are still to the upside until other cues come into play.

KRW: A Rude Awakening

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDKRW	**1130** (1060)	**1110** (1055)	**1100** (1050)	**1090** (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** USDKRW saw a sharp reversal higher (+4.8% from 1066 in early Jun to 1117 on 27 Jun) for the month of Jun. Bias has shifted for AXJs including the KRW to remain under pressure but we do not rule out the possibility of technical retracement given the sharp move in a short span of time. We do not rule out retracement towards 1100 levels in the short term but pair could still stay supported in the range of 1100 – 1140 in the few weeks ahead.

- The magnitude of the up-move in USDKRW caught us by surprise (a rude awakening). This was largely triggered by external factors including (1) an escalation of trade war between US and China (tit-for-tat tariffs could be formally imposed on 6th Jul) potentially may exert downward pressure on growth momentum and add to upward pressure on prices; (2) sharp move higher for USDCNH (from 6.38 to 6.60) de-anchoring sentiment in AXJs resulting is sharp depreciation in the AXJ currencies; (3) faster pace of global stimulus withdrawal (as Fed's forward guidance showed a quicker pace of normalisation, ECB announced QE exit plans this year/signaled rate moves in 3Q 2019 while BoE signaled possible rate hike in Aug and balance sheet reduction in 2019) should tighten financial conditions and weigh on risk assets; (4) import tariffs or protectionism typically could result in higher inflationary pressures for the US. Given that growth momentum in US remains intact, we see risks that Fed may have appetite to tighten further to arrest any excessive domestic price pressures. Not forgetting, oil prices could remain supported given the inability of OPEC members to meet planned marginal supply increases. The operating environment (i.e. synchronised global economic recovery) has also shifted into one that is multi-speed, led by US while other countries lagged. In light of the recent development (factors above-mentioned), shift in market environment and dissipating geopolitical positivity (as they have largely been priced in now) arising out of US-North Korea Summit, we revised **USDKRW forecast sharply higher from our prior forecasts but maintain the downward sloping trajectory over the forecast horizon to pencil in BoK rate hikes (possibly in 4Q) amid still-resilient growth conditions at home and signs that inflation may pick up further**.

- While trade tariffs between US and China could be imposed as early as 6 Jul (and there may be negative repercussions on growth momentum), we do not expect these tariffs to be in place indefinitely. A resolution at some stage could bode well for risk sentiment and investor confidence and this should benefit trade-dependent and high beta currencies such as KRW. However a prolonged implementation of tariffs and/or further escalation in protectionism measures (i.e. tariffs to be expanded to include more products or crackdown on Chinese investments in US tech companies) could result in KRW being much worse off than our forecast projections via the risk sentiment, investor/business confidence and real economy channels.

- **Growth and Inflation Outlook: South Korea's economy expanded 2.8% y/y in 1Q (unchanged from 4Q).** On a sequential basis, 1Q GDP rose +1.0% vs. -0.2% in 4Q, bolstered by exports recovery (rise in shipment of memory chips), corporate investment and government spending (due to policy change that increased the government's support for public health insurance). For 2018, BoK still expects the economy to grow by 3%, subject to global demand for memory chips and other manufactured goods. President Moon's proposed supplementary budget and wider budget deficit, to focus on job creation could further support growth, if it passes. Minimum wage increase (by about 16%) should also enlarge household wallet size and support private consumption.

- **Inflation moderated to 1.5% y/y in May (vs. 1.6% in Apr)** as lower prices for livestock products and utilities offset the jump in prices of agricultural products. Core CPI held largely steady at 1.3% in May. BoK projects CPI to pick up in 2H 2018, after remaining in the mid-1% range. For 2018, CPI is expected to be slightly below the level projected in Jan at 1.7%. Core inflation is still expected to rise gradually.

- **Monetary Policy Forecast**: We retain our view for BoK to keep policy rate on hold at 1.5% at the upcoming MPC meeting on 12th Jul. Though inflation is showing signs of picking up, the level remains below BoK's target of 2%. We see room for BoK to remain patient and keep monetary policy accommodative for the time being but expect a 25bps hike in 4Q 2018 if demand-induced price pressures picks up pace amid reacceleration in growth momentum. Minimum wage will increase by 16% this year, its largest magnitude of increase since 2001. Wage pass-through may have positive impact on consumption spending, growth and lead to inflationary pressures. The window of hike may shift from 3Q to 4Q 2018. BoK is expected to monitor if inflationary pressures from the demand side picks up and if higher oil prices over the past month translates into higher CPI prices ahead.

- There was no MPC meeting in Jun. At the last BoK meeting on 24 May, MPC kept policy rate on hold at 1.5% (unanimous decision), as widely expected. Accompanying statement noted that CPI will remain in the mid-1% range for some time this year and will gradually approach target in 2H; noted that solid trend of economic growth has continued; investment will slow but trend of steady increase in consumption will continue. BoK Governor Lee opined that EM rout does not seem contagious for now and do not see the possibility of stagflation in South Korea.

- **Latest Fiscal and External Balance Outlook:** Current account surplus narrowed to $1.77bn in Apr (vs. $3.67bn a year ago vs. 5.18 bn in Mar 2018). This is due to record deficit in primary account as dividend payouts to overseas investors reached a record high (seasonally takes place in Mar-Apr window). Services deficit improved thanks to jump in tourist arrivals amid China lifting travel ban. Nonetheless this marks the 74th consecutive month of current account surplus which started in Mar-2012 but surplus is also at its lowest level since 2012.

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

- **Key domestic events and issues to watch:** S. Korea releases Jun exports (1 Jul); PMI Mfg (2 Jul); Jun CPI (3 Jul); May current account balance (5 Jul); Jun unemployment rate (11 Jul); BoK meeting (12 Jul); Jun export/import price (13 Jul): Jun PPI (20 Jul); 2Q prelim GDP (26 Jul); Business survey for Mfg and Non-Mfg, Jun IP (31 Jul).

- **Technical Outlook:** USDKRW traded sharply higher for the month of Jun amid external market/political developments. Pair was last seen at 1115 levels. Price action also saw hanging man candlestick pattern (28 Jun) – this is a bearish reversal pattern in an uptrend and is generally associated with a sell signal. If USDKRW bears persist, there is a good chance the breakaway gap (since 19th Jun) could be closed. Any sharp move below 1095 could nullify the bullish sentiment in the pair. In addition bullish momentum on weekly and daily charts remains intact but shows early signs of waning while stochastics indicates overbought conditions. We do not rule out retracement risks in the near term, given stretched technical conditions. Immediate support at 1102, 1095. Move below these levels could see the pair trade decisively lower in the range of 1080 – 1100. Resistance at 1124, 1130. Bias to lean against strength.

SGD: Trade Disruption Risk Weighs

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDSGD	1.3750 (1.3100)	1.3650 (1.3000)	1.3600 (1.2900)	1.3550 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The SGD has been on the slide for most of Jun amid escalating trade tensions between China and the US. Fears of trade disruption from tit-for-tat tariffs between the two world's largest economies weigh on the more-open economies in Asia, including the SGD. The SGD breached the 1.37-handle for the first time since end-Oct 2017 at 1.3705 on 28 Jun. Further deterioration in risk appetite due to escalating trade tensions should weigh on the SGD and lift the USDSGD even higher from current levels in the near term.

- The imposition of tit-for-tat tariffs by US and China on each other effective 6 Jul should they fail to reach a trade agreement by then is a concern for trade-dependent economies like Singapore. Fears that this could escalate into an all-out trade war, disrupting trade flows, could weigh on sentiments and eventually on export growth.

- At the same time, the more rapid pace of Fed rate hike in 2018 amid healthy US growth and expectations of firmer inflation is supportive of the USD. The broad gains in the USD particularly against the AXJs, should weigh on the SGD. Trade war concerns and firmer USD are likely to be a drag on the SGD and keep the USDSGD elevated.

- Also possibly supportive of the USDSGD is our expectations for a softer USDCNY in the quarter ahead. PBoC's move to ensure two-way moves in the CNY and the potential disruption to the economy from Trump tariffs could see USDCNY firm. A firmer USDCNY should weigh on the SGD given increasing positive sensitivity of USDCNY move on the USDSGD.

- Still, Jul tends to be a seasonally strong month for the SGD vs. the USD, and there is a potential for a strengthening of the SGD in the month. This could possibly mitigate some of the downside pressure on the SGD and slow the USDSGD's climb higher. We could still see the pair climbed towards the 1.37 levels in the near term and even higher by end-3Q.

- This SGD weakness is despite the relatively resilient economy where manufacturing and export growth has expanded by double-digit in May. Industrial output rose 11.1% y/y while NODX expanded 15.5%. Any headwinds from trade disruption risks arising from trade war will likely manifest in the manufacturing and trade prints only towards the end of the year. Any slack from manufacturing and trade could be taken up by a private investment recovery in the economy (as firms expand capacity to meet rising domestic and global demand).

- Risks of a global slowdown from trade disruption are likely to be met by accelerated government spending as in past episodes. The government could accelerate its infrastructure programme, including developing Changi Airport Terminal 5 and redeveloping and rejuvenating the Jurong Lake District. In addition, Jurong Region MRT Line scheduled to start limited operation in three phases from 2026 could also be accelerated. Together, these should keep economic growth supported beyond 2018.

- Healthy domestic macroeconomic fundamentals should backstop any dips in the SGD. Aside from the country's healthy room for further fiscal policy, its triple-A status and persistent high balance of payments surpluses should be supportive of the SGD. These should provide incentive for investors to remain vested in Singapore assets, including the SGD. Taken together, the healthy macroeconomic fundamentals should keep the SGD supported and keep the USDSGD on its gradual downward trajectory going into 2019.

- Given ongoing global risk aversion plays, we have tweaked our forecast to the USDSGD accordingly. We now expect the USDSGD to remain elevated and inch higher to 1.3750 (previously 1.31) by end-3Q but then ease off towards 1.3650 (previously 1.30) by end-2018 as trade tensions ease. Thereafter, the pair is projected to trade end-1Q and -2Q 2019 at 13600 (previously 1.29) and 1.3550 respectively

- **Growth and Inflation Outlook:** After expanding by a better-than-expected 4.4% in 1Q 2018, the growth momentum looks poised to continue into 2Q. Already industrial production has accelerated by 11.1% y/y in May from 9.1% in Apr, while retail sales rebounded to 0.43% y/y after slipping by 1.10% in Mar. At the same time, external demand has proven to be relatively resilient with NODX expanding by 15.5% y/y in May, the second straight month of double-digit growth. All these points to a relatively good start to 2Q economic growth. This together with resilient services growth leads our economic team to pencil in growth of around 4.3% y/y for flash estimates 2Q GDP (due sometime second week of Jul). For the whole of 2018, the team is looking for real GDP to come in at 3.5% in 2018, while MTI expects GDP to come in at within 2.5-3.5%.

- After disappointing in Apr, May's inflation print showed inflation creeping higher underpinned by rising global oil prices that pushed up petrol prices and the rise in services and retail inflation. Headline inflation rose 0.4% y/y in May from +0.1% in Apr and in line with expectations. The stronger print was due to the rebound in private road transport cost (May: +0.1% vs. Apr: -0.8%) after two straight months of decline, lifted by steeper increases in petrol prices. At the same time, smaller year-ago drop in Certificate of Entitlement premiums also weighed. Accommodation costs also fell but more moderately (May: -3.2% vs. Apr: -3.6%) on slower declines in housing rentals. Core inflation (headline inflation less accommodation & private transport) rose 1.5% in May from Apr's +1.3%, reflecting higher services and retail inflation. Services inflation climbed to 1.6% (Apr: +1.3%), helped by larger increases holiday expenses and airfares and more moderate drop in communication fees. Retail inflation edged higher on account of medical cost and appliances & equipment. Year-to-date, headline and core inflation have averaged +0.2% and +1.5% y/y respectively.

- As inflation to date has underperformed expectations, our economic team has revised downwards its headline inflation forecast to +0.7% from +0.9% for 2018. The team though has kept its core inflation outlook unchanged at +1.7% to reflect the administrative price hikes (Changi Airport fee and water prices) and greater pass-through into consumer prices from rising oil prices. Consequently, the team maintains its headline and core inflation forecast at +0.9% and +1.7% respectively for 2018. MAS continues to look for core inflation to rise gradually for the rest of 2018, averaging at the upper half of its 1-2% forecast range for 2018. Similarly, it expects headline inflation to come in at the upper half of its 0-1% forecast range for 2018.

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

- The USDSGD has been on the uptick since mid-Jun as trade war concerns escalated, particularly following the tit-for-tat tariffs to be imposed by China and the US. Pair has broken above the psychological 1.36-level to touch briefly broke above the 1.37 levels to 1.3705 (on 28 Jun). Pair has since eased off to hover around the 1.3670-levels. The firmer USDSGD and rising 10Y UST yield so far have not unsurprisingly kept the 3-month SOR supported around the 1.61-levels. This though is off the 2018 high of 1.73% on 10 May - a level not seen since 13 Jan 2016. Meanwhile, 3-month SIBOR continues to edge higher, climbing to a new 10-year high of 1.5207% on 20 Jun. Both the 3-month SOR and 3-month SIBOR remain elevated as the withdrawal of monetary stimulus in the other advanced economies that had kept the global financial markets flushed with liquidity continues. We are now gradually seeing mortgage rates respond to the climb in domestic rates. Deposit rates (for 12-month fixed) also continues its slow grind higher, now hovering around the 0.37%-levels since end-May. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, remain on the gradual uptick.

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

- **Latest Fiscal and External Balance Outlook:** The government budget plans for FY2018 revealed a budget surplus of SGD9.6bn (2.1% of GDP) in FY2017. This not only far exceeded the projected surplus of SGD1.9bn but also the highest budget surplus as a % of GDP since FY2007 where growth was strong. For FY2018, the government is conservatively projecting a negligible budget deficit of 0.1% of GDP for FY2018.

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

- **Key domestic events and issues to watch:** Advanced estimates for 2Q18 GDP will be released sometime 9-13 Jul, while CPI for Jun is due 23 Jul.

- **Technical Outlook:** Our technical bias in the last FX Monthly for USDSGD to head towards 1.33 levels panned out well in the first week of Jun. Pair traded a low of 1.3308 (7 Jun) before rebounding to fresh-2018 high of 1.3705 (28 Jun). Last seen at 1.3635 levels. Bullish momentum on weekly and daily chart remains intact but shows tentative signs of waning. Stochastics shows signs of turning lower from overbought conditions. We do not rule out retracement risks towards 1.3610 (23.6% fibo retracement of Jun low to high), 1.3550 (38.2% fibo). Resistance at 1.37, 1.3780.

MYR: Feeling the Effects of Fragile Global Risk Assets

Forecast	3Q 2018	4Q 2018	1Q 2018	2Q 2019
USDMYR	4.0800 (3.8500)	4.0300 (3.8000)	3.9800 (3.8000)	3.9800 (3.6500)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** In line with most other regional currencies, the MYR weakened against the USD by around 1.6% in the month of June. It reached a high of 4.0460 on 29 June 2018, due to uncertainties from the escalation of trade war and the recent interest rate hikes by Fed. The weaker exchange rate also reflects the drop in crude oil price which fell -6.5% to USD74/bbl at 21 Jun 2018 from this year's high of USD79.2/bbl on 23 May 2018, but on year to date basis crude oil price has appreciated +10.7% from USD66.8/bbl. The drop in reserves level may indicate BNM using reserves to contain further weakness in MYR.

- Latest developments in the RMB which had played an anchor of stability for Asian FX also led to some impact on MYR. In particular, the RMB losing its safe-haven status as USD strengthened, partly driven by a few factors such as seasonal dividend payments by Mainland companies, unwinding of short positions by offshore real money and a general shift in sentiment caused by fears of repercussions from the economic conflict with the US. At the same time PBOC was absent in trying to slow the depreciation.

- We are also mildly revising to the upside our near-term forecasts for USD against the rest of the G3 as we further price-in market fears about the risk of a possible global trade war becoming more sustained, coupled with continuing Fed policy normalisation and repatriation of corporate earnings, which may further add to USD tightness. In that base scenario, riskier and commodity currencies are likely to remain vulnerable. Further out, we continue to anticipate more USD underperformance on the back of a further flattening of the UST yield curve and concerns about the deteriorating US twin deficits.

- In addition, our economics team sees rising likelihood that the BNM could keep rates on hold until 2019 to support domestic demand especially consumer spending. Taking all these into consideration, we revise our G7 forecasts leading to adjustments to our dollar levels and as a result, we revise higher again our USDMYR forecasts for this year.

- Nonetheless, MYR fundamentals remain well anchored by sustained current account surplus, rising FX reserves to retained imports & short-term debt, sustained growth pick-up backed by consumption, investment and exports as well as higher oil prices. We maintain our lower USDMYR forecast trajectory beyond 2018 on efforts taken by the new government to improve governance, transparency and accountability. However, we acknowledge there could still be some uncertainty over the next few years as the new government navigates the new political environment and foreign investors still remain somewhat cautious for now. Domestically some concerns about a pullout in some of the investment projects from the previous administration may have inadvertently affected sentiment in the short term, although our medium term view remains supportive of the currency.

- As such taking into consideration both domestic and external factors, we now have a slower pace of MYR appreciation vis-à-vis the dollar, consistent with our USD weakness view in the medium term. On the domestic front in the short term, the earliest time for more policy clarity and more details is likely July, early Aug, so before this a weak MYR bias coupled with USD strength will likely persist, before some element of certainty comes from the Budget 2019 in Oct. Overall in the short term, domestic policy uncertainty risk may still somewhat weigh on the MYR despite solid fundamentals.

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

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

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

- External reserves fell by -USD0.6b to USD107.9b in mid-Jun 2018 from USD108.5b in end-May 2018 amid foreign selloffs in local equity following increased risk aversion by foreign investors towards Emerging Markets. The latest tally is equivalent to 7.5 months of retained imports and 1.0 times of short-term external debt. Net equity portfolio capital outflows Foreigners were net sellers of Malaysian equities totaling -MYR2.1b for the 1-15 Jun 2018 period (May 2018: -MYR5.6b). Net foreign selling in the equity market was mainly attributed to the US Fed's interest rate decision (12-13 Jun 2018), trade issues/disputes at the G7 meeting (8-9 Jun 2018) and continued US-China "trade war", causing volatility in the financial markets and dragged the KLCI down by -1.97% month-to-date to 1,706 points at 21 Jun 2018. Net outflow may persist through, as the net outflow of –MYR4.1b reported year to date (Jan-15 Jun 2018) is still small as compared to the net inflow of MYR10.6b worth equities reported in 2017.

- Meanwhile, data on foreign flows in the bond market for Jun 2018 is not yet published, but our Fixed Income (FI) Research team expects net selling by foreigners to continue this month after the –MYR12.9b net sell in May 2018. However the dips in MGS yields this month after the postGE14 rise last month may indicate some stabilization in the local bond market. The 3-Year yield eased to 3.61% as at 21 June 2018 after it climbed to the high of 3.75% on 28 May 2018 from 3.65% on 8 May 2018. Similar trend was observed in the 10-Year yield which dropped to 4.21% yesterday compared with the high of 4.26% on 26 May 2018 vs 4.15% on 8 May 2018.

- The recent monetary policy decisions by the major central banks such as ECB announcing to end its bond buying programme soon and the more hawkish view by the US Fed may result in foreign funds leaving EM, including Malaysia in search for better yields elsewhere. Fed funds rate (FFR) was raised by +25ps to 1.75%-2.00% at the 12-13 June 2018 FOMC, the second rate hike this year after the +25bps increase at the 20-21 Mar 2018 FOMC meeting. We expect the remaining two rate hikes for this year to come in at the 25-26 Sep 2018 and 18-19 Dec 2018 FOMC meetings. Meanwhile the European Central Bank (ECB) announced that it will half its bond buys to EUR15b (USD13.1b) by Oct 2018 then shut the programme at the end of the year. ECB also sees interest rates steady "at least through the summer of 2019".

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

- **Growth and Inflation Outlook:** Our economics team expects economic growth to moderate to 5.1% this year (2017: 5.9%), mainly reflecting the impact of the measures and policies of the new Pakatan Harapan (PH) Government announced so far. The zero-rating of GST between June-Aug 2018 and its abolition in Sep 2018 as well as the fuel price stabilisation programme until end-2018 are expected to boost consumer spending growth. However, the impact of these measures on Government revenues and spending amid the commitment to achieve the Budget 2018's deficit target of -2.8% of GDP will result in prudent Government spending. Meanwhile, review of major infrastructure projects could pose some risk to investment outlook. Our full-year growth forecast implies moderation in quarterly growth in 2Q-4Q 2018 after the 5.4% expansion in 1Q 2018. At this juncture, we expect +5.3% growth in 2Q 2018 before growth decelerate further to around 4.8%-5.0% in 2H 2018.

- Other than the external risks such as trade tension between US and its major trading partners as well as China's growth slowdown, current main issue on the domestic front is details and clarity of Government policies. A key policy event to watch in the tabling of Budget 2019 on 2 Nov 2018 amid question on whether Malaysia can maintain its budget deficit consolidation since 2010 given the reversals in previous Government's fiscal reform measures (i.e. introduction GST, fuel subsidy abolition).

- External trade figures have been volatile so far this year, resulting in slower year-to-date total trade growth of +4.9% (Jan-Apr 2017: +19.4%). External trade growth outlook are clouded by several factors. Short term forward looking indicators for exports point to the downsides following the fifth consecutive month of decline in imports of intermediate goods (Apr 2018: -11.9% YoY; Mar 2018: -14.5% YoY), and the fourth consecutive month of dip in manufacturing purchasing managers index (PMI) to a 11 month low of 47.6 in May 2018 or –2.3% YoY (Apr 2018: 48.6 or -4.1% YoY). The PMI survey for May 2018 highlighted that weak new orders was the key reason for downtrend as the sub-index of new export orders fell for the fourth month. At the same time, the "on-and-off" US-China trade tension returns coupled with the risk of spreading to other major US trade partners, namely EU, Canada and Mexico. Meanwhile, the review of major infrastructure projects by the new Government is expected to dampen imports of capital goods, adding to the abovementioned weakness in imports of intermediate goods. Our current full-year growth forecasts are +6.0% export growth (Jan-Apr 2018: +7.8%; 2017: +18.9%); +3.5% import growth (Jan-Apr 2018: +1.6%; 2017: +19.9%) and +MYR123.2b trade surplus (Jan-Apr 2018: +MYR46.4b; 2017: +MYR97.2b).

- Both headline and core inflation rate remained sub-2% for the fourth straight month in May 2018 at +1.8% YoY (Apr 2018: +1.4% YoY) and

+1.5% YoY (Apr 2018: +1.5% YoY) respectively. No change to our 2018 headline inflation rate forecast at +1.5% to +2.0% range (Jan-May 2018: +1.7% YoY; 2017: +3.7%). Overnight Policy Rate (OPR) to stay at 3.25% for the rest of this year after the +25bps hike on 25 Jan 2018.

- The increase in headline inflation in May 2018 was driven by FNAB, despite the smaller rise (May 2018: +2.2% YoY; Apr 2018: +2.6% YoY), sustained increase in HWEGOF (May 2018: +2.1% YoY; Apr 2018: +2.0% YoY) and bigger rise in transport costs (May 2018: +3.8% YoY; Apr 2018: +0.4% YoY). Headline inflation for Jan-May 2018 period stays subdued at +1.7% YoY while core inflation at +1.8% YoY during the same period. We maintain our 2018 inflation rate forecast at +1.5% to +2.0% range primarily on implementation of two key policies to-date under the new Pakatan Harapan (PH) Government that are expected to keep a lid on inflation this year.

- The two policy announcements that affect inflation rate are the cut in GST rate to 0% from 6% on all standard-rated goods and services effective 1 June 2018, and the de-facto return of fuel price subsidy as domestic fuel prices are maintained at current levels effective 7 Jun 2018. Nevertheless, RON97 price was floated on a weekly basis to reflect current global crude oil price movements. RON97 price was fixed at MYR2.66/ltr for 7-13 Jun 2018 period and later revised downward to MY2.60/ltr for the week 14-20 Jun 2018. Meanwhile, prices for RON95 and diesel remain unchanged at MYR2.20/ltr and MYR2.18/ltr respectively as the government subsidized RON95 and diesel prices at MYR0.33/ltr each. Prices for RON97, RON95 and diesel were unchanged at MYR2.47/litre, MYR2.20/litre and MYR2.18/litre respectively during 22 Mar-6 Jun 2018 period under the previous weekly managed float system. This was despite Brent price consistently rising at double-digit growth during the period.

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

- Furthermore, unless the US Fed turns very aggressive on its interest rate hikes vs the current guidance, there is currently "positive carry" in terms of the differences between Malaysia and US interest rates and between domestic interest rate and inflation rate which should not necessitate further interest rate hike this year. Malaysia is also ahead of the curve marginally in normalizing its interest rate i.e. since 2011, as the current OPR is just 25bps short of the pre-GFC peak of 3.50%.

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

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

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

- On oil prices, our Economists shared that every US$10/bbl increase in annual average crude oil prices will boost government revenues by MYR7-8bn via oil related revenues. Last year's average crude oil price averaged US$54/bbl, up from US$44/bbl in 2016. And YTD 2018, crude oil price averaged about US$69. Theoretically the US$15 increase in crude prices from 2017 works out to a potential increase in government revenues by MYR10.5bn – 12bn.

- Potentially higher government revenues from increase in oil prices could partially buffer against revenue losses from removal of GST and re-instatement of fuel subsidy.

- We had previously shared that brent could be poised for further upside, with next objective seen at $82 (61.8% fibo retracement of 2014 peak to 2016 trough). Support levels seen at $71.50, $61 levels. Upside risks to oil prices suggest room for positive surprise as government budget assumption (Budget 2018) for oil prices was conservative at $52/bbl.

- **Key domestic events and issues to watch:** Trade data (7 Jul); FX reserves (6 & 20 Jul); Industrial Production (12 Jul); CPI (18 Jul), BNM Policy Meeting (11 Jul).

- **Technical Outlook:** Pullback in USDMYR was shallow and confined to the first few trading days in Jun. Pair subsequently traded higher. Last seen at 4.0370 levels. Bullish momentum on weekly chart remains intact while stochastics is rising into overbought conditions. Stretched technical may limit the upside and a pullback in the short term is not ruled out. Support at 4.0080. Resistance at 4.0530, 4.08 levels.

IDR: Still Vulnerable To External Headwinds

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDIDR	14450 (13600)	14250 (13500)	14100 (13400)	13900 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The IDR continues to be the worst performing currency in ASEAN in Jun despite the two consecutive 25bp rate hikes in two months. The gains in the IDR from these two rate hikes have almost been wiped out. BI's dual intervention in the FX and bond markets, spending about USD9bn of its foreign reserves over the past four months failed to produce the desired results. The IDR weakness so far can be attributed to the Fed's rate hike and forward guidance of two further hikes in 2018, as well as the escalating trade tensions between the US and China. Simmering in the background as well is emerging market risks that had already taken a toll on the currencies of Turkey and Venezuela.

- Marking the IDR as vulnerable to market reversal is its twin deficits in the current and fiscal accounts. In addition, the high foreign ownership of Indo sovereign bonds is another indicator of the economy's exposure to the global markets. Given rising global risks and domestic vulnerabilities, foreign investors have pulled out funds from Indonesian assets. Foreign investors have sold nearly USD671.9mn so far in Jun. This was largely due to expectations of corporate earnings given lackluster private consumption and concerns of a slowdown in exports that have weighed on demand for equities by foreign investors. Surprisingly, the efforts by BI to stabilize the debt market and IDR have spurred a return of foreign funds into debt with USD46.8mn purchased in the month so far. Nevertheless, the net foreign portfolio outflow weighed on the IDR, which fell 1.47% against the USD so far in Jun. Further net foreign portfolio outflows should weigh on the IDR.

- The imposition of tit-for-tat tariffs by US and China on each other effective 6 Jul should they fail to reach a trade agreement by then is a concern for commodity-exporting currency like the IDR. Fears that this could escalate into an all-out trade war, disrupting trade flows, could weigh on sentiments and weigh on the economy's terms of trade as well as inward FDI activities. Meanwhile, the expectations of more aggressive Fed rate hike in 2018 amid healthy US growth and expectations of firmer inflation are supportive of the USD. The broad gains in the USD particularly against the AXJs, should weigh on the IDR. Thus, trade war concerns and firmer USD are likely to be IDR-negative and we could see the USDIDR test the 14500 levels in the very near term before easing lower towards end-3Q.

- The firm commitment by new BI governor Perry Warjiyo to use monetary policy to stem IDR and bond markets instability had helped calm the markets to a certain extent. His pledged to be "more pre-emptive, front-loaded and ahead of the curve in terms of rate policy" have burnished the credibility of the central bank. This was manifested in his two 25bp rate hikes in two weeks and a 50bp rate hike on 29 Jun. The benchmark 7-day reverse repo rate is now at 5.25%. This should incentivise the return of foreign investors into Indonesian debt and provide some support for the IDR for now, allowing the USDIDR to edge lower by end-3Q from current levels.

- At the same time, <u>Jul tends to be a seasonally strong month for the IDR vs. the USD. In seven of the past 10 years, the IDR has strengthened in Jul. Thus, there is a potential for the IDR to strengthen in the month.</u> This could help offset some of the downside pressure on the IDR from trade war concerns and Fed rate hike moves. The IDR could rebound from its moves lower as a result with the USDIDR ending 3Q around 14100 levels.

- Relatively healthy economic growth of 5.1-5.5% in 2018 driven by the synchronous global recovery and government spending on infrastructure should remain supportive of the IDR. The government's USD400bn infrastructure programme is expected to not only bolster near term growth but potential growth as well. In addition, campaign spending ahead of legislative and Presidential elections on 17 Apr 2019 should also keep the growth momentum going. Spending in preparation for the Asian games slated to take place 18 Aug-2 Sep should be supportive of growth ahead, while the 15 reform/stimulus packages introduced so far should help to cut red tape and liberalize rules that have been a drag on the economy. In addition, expectations of broad USD downtrend in the medium term remains intact and this should weigh on the USDIDR. Together, these should allow the USDIDR to continue its slow grind lower over the next three-twelve months.

- Trade war concerns, Fed rate hike moves and twin deficits amid higher oil prices should continue to put downside pressure on the IDR in the very near term. Renewed confidence in BI credibility (including the recent 50bp hike in the policy rate), together with ongoing intervention in both the FX and debt markets, are unlikely to completely offset IDR weakness in Jul. Consequently, we have tweaked our USDIDR forecast to reflect these recent developments. We now expect the USDIDR to end-3Q at 14450 instead of 13600 previously.

- However as trade war concerns fade and the economic momentum picks up underpinned by the acceleration of the government's USD400bn infrastructure spending, and campaign spending ahead of, legislative and Presidential elections scheduled on 17 Apr 2019, the IDR should be buoyed. In addition, spending in preparation of the Asian Games (18 Aug-2 Sep) should also boost growth momentum and hence keep the IDR supported. We look for the USDIDR to trend gradually lower to 14250 by end-2018. In 1H 2019, some volatility in the markets can be expected as the Presidential election approaches. We are penciling in a Jokowi win at this juncture, which should be supportive of the IDR. This scenario, together with easing trade concerns, should allow the USDIDR to edge further lower to 14100 (13400 previously) and 13900 by end-1Q and -2Q 2019 respectively.

- **Growth and Inflation Outlook:** After sluggish 1Q growth of just 5.06%, the economy is poised to accelerate in 2Q. According to BI, fiscal policies, including 13th-month pay and holiday bonus for the Eid celebrations, are expected to bolster growth in 2Q. Already motorcycle and motor vehicle sales have risen with the former up by 10.9% in May and the latter by 14.1% in Apr respectively. Note that motorcycle sale is a proxy for consumer spending, and its rise is an indication of stronger private consumption ahead. Our economic remains sanguine about growth prospects for the rest of the year. The team looks for government spending and supported external demand to boost growth ahead. We expect the growth momentum to be sustained beyond 1Q 2018 on the back of the President's USD400bn infrastructure programme push. In addition, accelerated infrastructure spending ahead of legislative and Presidential elections in Apr 2019 should keep the growth momentum going. Spending in preparation for the Asian games slated to take place 18 Aug-2 Sep is also supportive of growth ahead. While higher interest rates are likely to dampen private spending to some extent, macroprudential measures, especially for home buyers, could mitigate some of this risk. BI governor Warjiyo expects the economy to expand by 5.2% in 2Q consequently. For the full-year, BI projects GDP growth of 5.1-5.5% in 2018, while our economic team looks for growth of 5.30% for 2018.

- Headline inflation decelerated in May, rising by 3.23% % y/y vs. 3.41 in Apr. Food prices, housing cost and transport cost rose by a more moderate 4.47%, 2.50% and 1.70% respectively vs. Apr's 5.15%, 2.81% and 1.75%. Ongoing efforts by the government to improve food supply and control prices of key commodities via stricter monitoring have helped to keep food inflation down to a certain extent. Core inflation though continued to accelerate for the third straight month, rising 2.75% y/y in May vs. 2.69% in Apr, possible lifted by higher clothing and education costs. Further climb in consumer prices could be a slow grind given that the government is planning to continue to subsidise diesel fuel at the current rate and also increase its subsidies for electricity. Diesel subsidies will rise by IDR500 to IDR2000 a litre. Still, IDR weakness is likely to remain a source of inflationary pressure, driving up imported good prices, including oil. Our economic team expects headline and core inflation to come in at 3.52% and 2.41% respectively for 2018 as compared to BI's target range of 2.5-4.5%.

- **Monetary Policy Forecast:** After lifting its benchmark policy rate for twice in two weeks, BI surprised again at its 28-29 Jun meeting by hiking the 7-day reverse repo rate by 50bp to 5.25%. Market had been expecting just a 25bp rate hike. The deposit and lending facility rates were also raised by 50bp accordingly to 4.25% and 6.00% respectively. The interest rate corridor was maintained at 75bp on either side of the policy rate. According to the governor, this was another pre-emptive move triggered by external factors, possible concerns over trade wars that have hit the IDR hard. Unlike the previous inter-meeting hike, there was no commitment by the BI to hike rates further if needed. But we believe that a rate hike would be forthcoming should the situation requires it. For now, we expect BI to remain on hold to watch the impact of the three rate hikes on the real economy. At the same time, the BI also announced the relaxation of loan-to-value (LTV) rules effective 1 Jul as expected. At the same time, buyers of their first home were exempted from LTV rules. This should help mitigate concerns that higher interest rates would dampen home purchases and should be supportive of economic growth.

- **Latest Fiscal and External Balance Outlook:** Finance Minister Sri Mulyani said that the budget deficit came in at IDR94.4tn in May or equivalent to 0.64% of GDP. This was almost doubled the deficit in Apr, which was 0.37% of GDP. Expenditure was at IDR779.5tn, while revenue collected was IDR685.09tn. Non-tax oil revenue from oil and gas rose together with oil prices, while non-oil tax revenue rose 18.4% y/y. The government is planning to keep the budget deficit below the 2.19% target set for this year. Our economic is less sanguine on the government's ability to hold down the deficit and instead is penciling in a deficit of 2.50% for 2018.

- The current account deficit narrowed in 1Q 2018, coming in at USD5.54bn (2.15% of GDP) compared to USD6.04bn in 4Q 2017 (or 2.34% of GDP). The narrower deficit was due to the improvement in the goods and services surplus (1Q18: USD0.93bn vs. 4Q17: USD0.80bn). This was due to higher deficit in the services account and also a moderation in the surplus in the goods account. The financial account surplus narrowed to USD1.81bn in 1Q compared to USD6.8bn in 4Q due to moderation in net direct investment and the outflow for net portfolio investment. Consequently, the overall balance of payments flipped to a deficit of USD3.85bn vs. a surplus of USD0.97bn in 4Q. For 2018, the BI expects the current account deficit to widen to 2.0-2.5% of GDP, but FinMin Sri Mulyani is penciling in a deficit of around 2.5%. She has recently said that the government is discussing ways to control the current account deficit. Some of the measures being considered included steps to strengthen policy on exports, tourism and developing industries that can substitute imports. Success in this area would be positive for the IDR. Our economic team expects a deficit of about 2.2% of GDP.

- **Key domestic events and issues to watch**: BI will meet to decide on monetary policy on 19 Jul. Before that, CPI for Jun is on tap 2 Jul.

- **Technical Outlook:** USDIDR was last seen at 14330 levels. Bullish momentum on daily chart remains intact but stochastics is turning from overbought conditions. Pair could reverse strength in the near term. Support at 14210, 14080 levels. Resistance at 14400, 14500.

PHP: BSP Credibility Restored But Headwinds Remain

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDPHP	54.00	53.50	54.00	53.80
	(52.50)	(52.00)	(52.00)	(--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The PHP has gone from "zero-to-hero" all in the space of one month. After being the worst performing ASEAN currency in May, the PHP is performing better than most of its peers in Jun except for the MYR. Support for the PHP came from BSP's two consecutive rate hikes that lifted the policy rate to 3.50% on 20 Jun. Nevertheless, the optimism from the rate hikes and expectations of further moves by the BSP have been more than offset by the global concerns over trade wars. In addition, simmering in the background remains concerns over emerging market risks that could re-emerge to weigh on the PHP. This has dragged the PHP to a multi-year low of 53.630, though it has since rebounded from that level. Risk aversion though could rise as trade tensions escalate, weighing on the PHP and lift the USDPHP even higher from current levels and from our previous forecasts.

- Trade tensions between the US and China could blow-up into a trade war should the two sides fail to reach a trade agreement by 6 Jul. 6 Jul is the date when tit-for-tat tariffs will be imposed by US and China on each other's exports to their respective economies. An all-out trade war will dampen global sentiments and eventually on export growth that could impact the PHP negatively, given its twin deficits. At the same time, expectations of even further rate hikes by the Fed in 2018 amid healthy US growth and expectations of firmer inflation could lift the USD higher. The broad gains in the USD, particularly against the AXJs, should weigh on the PHP. Thus, concerns over escalating trade tensions and firmer USD are likely to put downside pressure on the PHP and keep the USDPHP elevated.

- There is a risk that the USDPHP could overshoot in the near term, exacerbated by concerns over the country's twin deficit. The deteriorating current account deficit continues to be an albatross over the economy. Aside from Indonesia, the Philippines is the only economy suffering from current account deficits. However, unlike Indonesia, the broad trend in the current account deficit has been to the downside since 2015. The government's ambitious infrastructure building programme should keep the current account in deficit for at least in 2018 and possibly into 2019.

- At the same time, downside risks to overseas remittances growth remains. The expected slowdown in repatriation from Filipino workers in Kuwait and from government policy on tightening immigration suggests that remittances are unlikely to improve the current account deficit significantly. In addition, the current account deficit could widen even more on elevated oil prices (in value terms) given that Philippines is an oil-importing economy.

- The fiscal deficit is also showing little signs of improvement. The tax reforms championed by President Duterte have yet to improve revenue collection significantly and reverse the fiscal deficits that had plague governments for the longest time. The fiscal deficit instead is likely to worsen given the ambitions infrastructure building programme of the government. An added concern is that the government could spend more of its revenue collected to service interest payments rather than on development.

- Like its ASEAN peers, Jul tends to be a seasonally strong month for the PHP vs. the USD. In seven of the past 10 years, the PHP has typically strengthened against the USD in Jul. There is thus a potential the PHP to strengthen in the month. This could possibly mitigate some of the downside pressure on the PHP and slow the USDPHP's grind higher. In addition, jawboning and expectations of further rate hike by the BSP should be supportive of the PHP as trade war concerns fade towards the end of 3Q. Given that the central bank will use everything in its toolbox to maintain order in the financial market and stabilise the PHP, including further rate hikes, we are pencilling another 25bp rate hike to 3.75% in 3Q, possibly by its 9 Aug meeting the earliest. This should help reverse market perception that the BSP is "behind-the-curve" and this improvement in BSP credibility should be PHP-positive.

- To date, the PHP has not been receiving much support from foreign inflows. Foreign investors have so far sold USD262.4mn in equities in Jun. This has added to the sell-off in equities in 2018. The sell-off in equities by foreign investors has amounted to USD1.23bn year-to-date and this has weighed on the PHP. Still, there could be positive surprises coming from inflows into the stock market in 2018 once the current risk aversion episode fades. Based on our analysis using the Cyclical Adjusted P/E (CAPE) ratio model, domestic equities appears relatively cheap (as reflected by the estimated P/E ratios minus their 10-year average P/E ratios) compared to its regional peers. This is particularly given the expected strong economic performance this year. Greater inflows towards the end of the year should keep the PHP supported.

- Given the current risk-off environment, we have revised our USDPHP outlook for the next four quarters. We now expect the USDPHP to climb higher to the 54-levels (from 52.50 previously) by end-3Q on global risk aversion, but eased thereafter to 53.50 (52.00 previously) as trade tensions fade. Political risk could rise as elections for the House of Representative and half of the Senate (due 13 May 2019) approach, lifting the USDPHP higher back towards 54.00 by end-1Q 2019 (vs. 52.00 previously) before easing to and 53.80 by end-2Q 2019.

- **Growth and Inflation Outlook:** The government does not intend to let growth momentum slow in the quarters ahead even as the BSP lifts rates higher. The government's goal remains a growth rate of 7% for this year. The government spending is expected to underpin this growth momentum ahead. Altogether, the government plans to spend PHP8tn on its infrastructure building programme in its push to accelerate infrastructure building, including bridges, subway in Manila, a new airport north of Manila and railways connecting Manila to the provinces. This should mitigate the slowdown in contribution from exports and sluggish private consumption. Exports have been on the decline since the start of the year with the decline accelerating in Apr to 8.5% y/y. The spotty overseas remittances to date have not been encouraging for private consumption. In Apr, remittances rose 12.7% y/y – the fastest monthly growth since Nov 2016 but in the first four months of the year so far, remittances are up by just 3.5%, lagging behind the 4.3% seen for the whole of 2017. This is unlikely to suggest acceleration in private consumption ahead. Nevertheless, our economic team remains sanguine on growth prospects ahead due to government spending and is penciling in growth of 7.0% for 2018. For 2019, our team is looking at real GDP growth of 6.8%.

- Headline inflation rate (base year = 2012) continued to pick up in May 2018 to +4.6% y/y (Apr: +4.5% y/y) on sustained inflationary impact of the first phase of tax reform measures as well as elevated food (5.7% y/y), beverages (20.5% y/y), utility (3.0% y/y) and transport (6.2% y/y) costs. Core inflation (CPI excluding selected food items as well as energy prices) accelerated to 3.6%% y/y in May from 3.5% in Apr. the BSP is now looking for a slightly softer inflation print of 4.5% in 2018 vs. 4.6% previously after the recent rate hike. The central bank warned though that inflation risks remain to the upside on minimum wage hikes expected in Oct, possible fare hikes and elevated oil prices. It also highlighted that inflation could ease should the rice reform law be passed by Congress. For 2019, the BSP lowered its inflation forecast to 3.3% from 3.4% previously. Our economic team is still expecting inflation to average 4.2% and 3.8% respectively in 2018 and 2019 (based year = 2012). Using the 2006 base year, the forecast is 4.3% and 3.4% respectively.

- **Monetary Policy Forecast:** BSP lifted its overnight reverse repo rate by 25bp to 3.5% at its policy meeting on 20 Jun – the second consecutive rate hike this year. BSP had last hiked the policy rate by 25bp to 3.25% in May. At the same time, the BSP left the interest rate corridor intact with the overnight lending rate and overnight deposit rate were both raised accordingly by 25bp to 4.0% and 3.0% respectively. This keeps the interest rate corridor symmetrical on either side of the policy rate by 50bp.

- We had expected the BSP to remain on hold and any adjustment to take place only in 3Q against market expectations for a hike on 20 Jun. The move to hike rate in such a short-space of time was to anchor inflationary expectations. According to the Monetary Policy Statement, “follow-through monetary policy action” by the BSP was necessary on elevated “inflation expectations” for 2018 and “the risk of possible second-round effects from ongoing price pressures”.

- At the post-MPC press conference, the BSP governor Nestor Espenilla reiterated that any further rate hikes would be to keep inflationary expectations well-anchored and to ensure that inflation returns to its target rate of 2-4% in 2019. Despite the focus on inflation, we believe that growth concerns and the goal of achieving 7% growth this year remain the focus. This suggests that the hurdle for further rate hikes could be high. The governor reiterated at the press conference that future rate increases will be data-dependent. Eyes will thus be on the upcoming inflation print for Jun (due on 5 Jul).

- We however are not ruling out another rate hike by the BSP as the PHP should remain under pressure due to the twin deficit and moves by major economies to tighten monetary policy amid trade war concerns. The central bank is likely to use its "big toolbox" to address FX volatility and speculative activities as highlighted by the BSP governor. We believe that this would include the use of the policy rate. We are pencilling another 25bp rate hike to 3.75% in 3Q, possibly by its 9 Aug meeting the earliest.

- **Latest Fiscal and External Balance Outlook:** Latest tax from the Bureau of Internal Revenue showed that PHP172.5bn of tax revenues was collected in May. This collection exceeded the Bureau's PHP166.75bn goal by 3.4%. The outperformance by the Bureaus of Internal Revenue and Customs can be attributed to the tax reform implemented at the start of the year that raised levies on oil products and sugary drinks while cutting income taxes

- The balance of payments (BoP) deficit more than-doubled in May, widening to USD583mn from USD270mn in Apr. This brought the overall BoP balance to USD2.08bn in the first five months of 2018, wider than the deficit of USD1.23bn in 1Q. This is on the back of stronger good imports of 11% (vs. 10% previously) and good exports of 10% (vs. 9%). With the deficit now above the USD2bn mark, the BSP is now predicting a wider deficit of USD3.1bn (-0.9% of GDP) for 2018 as compared to USD700mn (-0.2% of GDP) estimated previously. The central bank has also revised up its BoP deficit for the whole of 2018 accordingly to USD1.5bn (-0.4% of GDP) vs. earlier estimates of USD1bn (-0.3% of GDP).

- **Key domestic events and issues to watch:** Key data in Jul includes CPI for Jun on 5 Jul and overseas remittances for May on 16 Jul.

- **Technical Outlook:** USDPHP traded higher for the month of Jun. Last seen at 52.450 levels. Bullish momentum shows signs of waning while stochastics is in overbought conditions. Support at 52.70, 52.10. Resistance at 53.65.

THB: Downside Risks Have Intensified

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDTHB	33.50 (31.50)	33.80 (32.00)	33.80 (32.50)	33.30 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** THB weakness has extended into Jun, weighed by the net foreign portfolio outflows amid escalating trade tensions and monetary policy divergence with the US and its regional peers. Broad USD strength against the AXJs is also weighing on the THB. The risk-off environment together with US strength has dragged the THB to a new 2018 low of 33.226 on 29 Jun. Taking into account this market development, we have revised upwards our USDTHB forecast.

- The sell-off in Thai assets extended into Jun with equities still bearing the brunt of the sell-off by foreign investors amid global risk aversion. Foreign investors have sold USD1.58bn in equities so far in Jun. In contrast, foreign investors had purchased USD0.25bn in debt in Jun. Concerns that escalation in trade tension could impact earnings of export-oriented Thai corporates could see further sell-off in equities ahead. In addition, there could be some re-allocation of assets away from Thailand as political uncertainty re-emerges in the run-up to the general elections expected early 2019. We could thus see further weakness in the THB in 3Q.

- Jul tends to be a seasonally strong month for the THB vs. the USD. In seven of the past 10 years, the THB has typically been stronger against the USD in Jul. While there is the potential for the THB to strengthen in Jul, we do not think that this will be sufficient to completely mitigate downside pressure to the THB from risk aversion. In fact, we cannot rule out a re-test of 2018 low at 33.226 and possible overshoot in the near term.

- Nevertheless, we do not expect the THB to fall even more aggressively towards the 34-levels. This is because healthy macro-economic fundamentals should continue to underpin the THB. In addition, persistent current account surpluses (around 10% of GDP) should be supportive of the THB. At the same time, we are looking for a pick-up in private investment to drive the next phase of growth and the THB higher. Our optimism arises from the high correlation between private investment and trade for Thailand. Thus, this current economic cycle should keep the economy and hence the THB supported. The government's push to accelerate infrastructure projects, especially the USD47bn Eastern Economic Corridor project ahead of general elections, could deliver upside surprises to domestic demand, growth and to the THB.

- At the same time, monetary policy divergence between Thailand and the US and its regional peers could see increased volatility in the THB as outflows form Thai assets intensify. For now, the persistent current account surplus and high foreign reserves should allow the BoT to delay rate hikes. However, as economic growth accelerates even more and consumer prices turn higher, the case for a rate hike will intensify. We expect a 25bp rate hike to take place sometime in 4Q and such a move would enhance confidence in the economy and be THB positive.

- However, political risk ahead is likely to weigh on the THB. Recent comments by PM Prayuth and Deputy PM Wissanu have both indicated that the general elections could be held by end-Feb 2019. The elections will take place after the coronation of HM King Vajiralongkorn, the date of which has yet to be confirmed. There are hints though that the elections could be pushed back to May 2019. Any delays to the general elections could lift political temperature even more and create further uncertainty going into 2019. This could keep investors on the sidelines until political uncertainty dissipates. Such political concerns are likely to put downside pressure on the THB in the next six months.

- Our base scenario for the general elections to proceed as planned in Feb 2019 remains intact. We believe that a majority government by a single party is unlikely given the new Constitution. A fractious parliament made up of smaller parties is likely with the Senate dominated by 250 members appointed by the military junta. This should allow the military to retain influence in the government as no single party will be able to command a majority. More likely than not, PM Prayuth should remain as PM as a result. We do not expect any change in economic policy direction and for the BoT to begin policy normalisation in 4Q 2018. Some initial volatility is expected in the aftermath of the election but we expect the THB to stabilise and continue on its appreciation path thereafter.

- With risk aversion in play currently, we have tweaked our THB forecast lower over the forecast horizon. We expect the USDTHB to end-3Q 2018 at 33.50 (vs. 31.50 previously). Pair should then climb higher towards 33.80 (from 32.00 previously) at end-2018 and 1Q 2019 on elections risk. Thereafter we expect the USDTHB to ease to around the 33.30-handle by end-2Q 2019.

- **Growth and Inflation Outlook:** After expanding by a stronger 4.8% y/y in 1Q 2018, we do not expect any let up in the quarters ahead. We continue to expect government spending to bolster growth for the rest of the year. Accelerated government spending can be expected ahead of the general elections. This together with planned infrastructure building projects including transport networks and the Eastern Economic Corridor should continue to bolster growth. Solid economic print in Apr suggested that growth momentum remained intact going into 2Q. Private consumption and private investment expanded by 5.5% and 7.03% y/y in Apr, accelerating from +2.2% and -0.39% in Mar. At the same time, there does not seem to be any let up in the ongoing synchronised cyclical recovery that has kept exports supported. Exports rose 11% y/y in May, while imports climbed 12%. We look for the export-led recovery to spark a revival in private investment that should sustain growth in 2018, given the high correlation between export recoveries and machinery & equipment investments for Thailand. Following in the footsteps of the NESDB, which had upgraded its 2018 growth forecasts to 4.2-4.7% from 3.6-4.6% previously in May, the BoT has similarly lifted its 2018 growth forecast to 4.4% from 4.1% previously. Our economic team's 2018 growth forecast is maintained at 4.5%.

- Headline inflation accelerated to 1.49% y/y in May vs. Apr's 1.07%, rising to the highest since Jan 2017. In the first five months of the year, headline CPI rose 0.89% y/y. Driving inflation higher in May was higher energy prices which lifted transport cost by 3.31% y/y compared to just 1.41% in Apr. Mitigating higher transport cost was the softer housing costs, which rose by just 1.12% in May vs. 1.50% in Apr. Food prices was relatively stable in May, rising by 0.74% y/y as compared to 0.68% in Apr. Core inflation (headline inflation excl. raw food and energy) rose by 0.80% y/y in May, faster than Apr's 0.64%. Given the bump up in inflation over the past two months, the BoT has revised upwardly its inflation forecast for 2018. It now looks for inflation to come in slightly higher at 1.1% in 2018 vs. its previous forecast of 1.0%. This still puts inflation at the bottom of its 1-4% inflation target range for 2018. Core inflation was kept unchanged at 0.7%. Our economic team expects 2018 inflation to come in a little higher than the BoT's forecast at 1.3%.

- **Monetary Policy Forecast:** There was no surprises from the BoT at its 20 Jun policy meeting. As expected, the central bank maintained its current monetary policy stance that has been in place since Apr 2015. The BoT held its benchmark policy rate - the one-day repo rate - steady at 1.5%. The last time the policy rate was even lower was during the Great Financial Crisis in 2009 at 1.25%. One member of the monetary policy committee though had voted "to raise the policy rate at this meeting in order to start building policy space". Despite the lack of unanimity, the majority agreed that 'monetary policy should remain accommodative' given the risks ahead, both domestic and external. Domestically, there is a need to "monitor the strength of the domestic demand and inflation developments" while externally, "the impact of trade protectionism measures".

- Despite these risks, the BoT is relatively bullish on domestic growth (as reflected in its upward revision of 2018 and 2019 growth), but remained bearish on inflation (with rates expected to hover just a tad over 1.0% in 2018 and 2019). The current environment of economic recovery amid a modest inflationary environment, together with its strong current account surplus and healthy reserves, should enabled the BoT to keep its policy rate at current levels for longer compared to its regional peers. However as growth returns to potential, a pick-up in inflationary pressures are likely. Accordingly, our economic team continues to look for the BoT to normalise this year and a rate adjustment is expected to take place in 4Q 2018.

- **Latest Fiscal and External Balance Outlook:** The National Legislative Assembly has approved the cabinet's FY 2019 draft budget in its first reading on 7 Jun. The budget involves a deficit of THB450bn from total expenditure of THB2.9tn and revenue of THB2.5tn. The government is now working on the final version of the budget to be implemented at the start of FY2019 on 1 Oct.

- The current account surplus narrowed even more to USD1.36bn in Apr from USD5.75bn in Mar. The weaker surplus was due to the sharp moderation in the trade balance to USD0.23bn (Mar: USD3.02bn) in Apr and smaller income account surplus of USD1.13bn (from USD2.74bn in Mar). The overall balance of payments narrowed to USD0.89bn in Apr vs. USD2.97bn in Mar. While details are unavailable at the moment, we believe that the strong investment outflows could have accounted for the milder overall BoP surplus in Apr.
- **Key domestic events and issues to watch:** CPI for Jun is on tap on 2 Jul, Customs trade for Jun sometime 19-24 Jul and trade figures compiled by the BoT on 31 Jul.
- **Technical Outlook:** USDTHB was on the up-move for Jun. Last seen at 33.15 levels. Bullish momentum on weekly and daily chart remains intact but shows early signs of waning. Stochastics is rising overbought conditions. Retracement risks towards 32.90, 32.50 not ruled out in the near term. We also observed the golden cross in the making - 50 DMA cuts 200 DMA to the upside. This is typically associated with bullish signal. Dips in the pair may still be supported. Meantime resistance at 33.30 (38.2% fibo retracement of 2016 high to 2018 low) before 33.90 (50% fibo).

INR: Headwinds Remain

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDINR	70.00 (66.00)	69.00 (65.00)	68.50 (64.00)	68.20 (63.00)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The strength of the USD continues to lift the USDAsians including the USDINR. With brent still in the upward trend channel that has formed since 2015, Venezuela having problems getting its production back to previous levels and concomitant negative impact on global spare capacity of crude production that should support oil prices, we anticipate USDINR to head higher in this environment. The ongoing trade war, which is negative yuan, also drags on most Asian currencies and Patel's non-committal stance on the next monetary policy move also could weigh on the rupee. There are a few silver linings arising out of this uncertain external environment, safe haven demands anchor US 10y rates and the fact that China could import a lot more from India. China's ambassador to India had tweeted about reducing or eliminating trade tariff on Indian imports including chemicals, agricultural & medical products, soy bean, clothing, steel and aluminum products.

- INR was one of the EM FX to be hurt by the current global trade friction. India was not granted exemption from the steel and aluminum tariff imposed by the US and would not be spared from the reverberations from the China-US trade spat. However, the key risk is still the rising brent prices that could lift the USDINR to 71.30. Technical analysis indicates that the momentum is bullish and the next resistance is seen there. Rising inflation stemming from higher brent and weaker rupee could eventually affect household consumption and India's growth prospects.

- **Growth and Inflation Outlook:** Industrial production growth quickened to 4.9%y/y, albeit still falling short of the expected 5.7%. Breakdown of the report revealed that the slowdown was broad based with only capital goods making strong rebound of 13.0%y/y in the month vs. the previous decline of 5.7%. Month-on-month, there was a decline in every sub-component. The rebound was less than expected and limits the room for a rate hike. The Nikkei PMI-mfg print for May came in at 51.2 vs. 51.6 previously. Output and new orders continue to rise but at a slower pace and cost pressure are intensifying. The cost pressure is indeed showing up as WPI beat expectations with a print of 4.43%y/y for May vs. the previous 3.2%.

- External demand was positive with exports up 20.2%y/y vs. the previous 5.2%. Imports growth quickened to 14.9%y/y vs. the previous 4.6%, lagging that of the outward shipment. Trade deficit widened though to U$14.6bn. Current account deficit narrowed a little to U$13bn vs. the previous U$13.5bn.

- CPI edged up to 4.87%y/y in May from previous 4.58%. Price pressure was broad based with only the house subcomponent holding steady while the rest including food, clothing and fuel rising. Impact of rising crude has started to seep in and could affect household consumption.

- **Monetary Policy Forecast:** RBI raised repo rate by 25bps to 6.25% and reverse repo by the same to 6.00%. We had warned of a real risk of RBI moving in Jun, an out-of-consensus. In fact, we saw compelling reasons that they should move in order to stay ahead of the curve given the fact that the latest CPI and WPI prints have surprised to the upside. The persistent rise in crude for much of the past few months have likely fanned price pressures and this is compounded by the weakness in the rupee. The strong Q1 GDP also allowed room for RBI to move and the central bank even pointed out that the output gap has "almost closed" and that could add pressure to inflation. Moving today can support the rupee and curb inflation.

- According to the minutes that was released on 20 Jun, all MPC members voted to raise the reverse repo rate by 25 bps because of increased inflation risks. Many noted the increase in capacity utilization rates and pick-up in business investment though some were a little concerned about the impact of rising crude on private consumption. While most were rather sanguine about growth, Dr. Pami Dua was concerned about global growth losing steam as anticipated by the Economic Cycle Research Institute, New York. The institute also warned of growth in ECRI's Indian Leading Exports Index in a deepening cyclical downswing. That could be a reason why the monetary policy stance is still neutral and that Patel clarified that the next rate action could be up or down.

- We expect that statement could be somewhat meant to be supportive of the bond market. By sounding too hawkish, expectations of rate hike have caused a U$6.3mn outflow for the quarter. Nonetheless, rising inflationary risks could still see bond outflows, current account and growth concerns. The external environment is negative for the INR. With most MPC members still fixated on the targets and fiscal policy possibly underpinning demand pull pressures on top of cost push, bonds remain at risk of another rate hike.
- The next RBI meeting comes on 1st Aug and higher inflation prints and the depreciating INR could keep the threat of another rate hike alive. In the past month, INR weakened 2.2% vs. the USD, smack in the middle of the Asia FX performance vs. the greenback. KRW is down -4.5% (leader of the pack) while JPY is down just -0.8%. RBI is likely to have intervened in the FX markets but another rate hike alone may not be able to stem the depreciation in the rupee.
- **Latest Fiscal and External Balance Outlook:** Finance Minister announced that the fiscal deficit for FY17 is poised to come in at 3.5%, well above the 3.2% projected as tax collections following the implementation of GST was lower than expected. For the coming year, the government estimates fiscal deficit to improve to 3.3%.
- It is worth noting that India is one of the emerging markets that are affected by the outflows. Month-to-date (26 Jun) recorded U$623.5mn outflow of equities and U$1.58mn for bonds. That totals up to U$6.3mn of bond outflows for the quarter so far. Risk of rate hikes is a key driver for India's bond outflows amid rising price pressure. Tightening liquidity conditions in the US also affect the rupee and capital flows.
- **Key domestic events and issues to watch:** PMI-mfg on 2nd Jul; CPI and IP on the 12th; trade data on 12-15th; WPI on 16th.
- **Technical outlook:** The monthly chart suggests increasing bullish momentum for this 1M USDINR NDF, last seen at 69.00. Stochs are higher as well and we look for a break of the 2015 high of 69.43 for a potential test of 71.30. Support is seen around 68.00.

VND: Trade War and Strong USD Weigh

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDVND	23100 (22750)	23000 (22740)	22900 (22780)	22800 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** For a country that is so reliant on trade and exposed to China, the ongoing trade war between the US and China has a definite negative impact on the VND. The USDVND rallied from a low of 22740 in May to a high of 22943 as we write today. Pressure remains to the upside as trade war does not seem to have a quick fix. The move higher in USDVND also coincides with the recent rally of the USDCNH and most of USDAsia. The VND NEER actually bounced last month, as most other higher beta Asian currencies actually weakened a lot more than the dong, not least the CNY. USDVND stands at a real risk of heading higher beyond the 23100 but could find some relief thereafter should trade tensions subside along with the US mid-term elections and we look for a mild retracement towards 23000.

- Vietnam still attracts foreign direct investment and the latest is the construction of the U$4bn Hanoi smart city project by Sumitomo that could begin in Sep. Ministry of Planning and Investment also announced that enterprises now take half as long to start business in Vietnam in 2017 compared to the year ago. After the surge in portfolio inflow seen in May, the amount of equity-related inflow normalized in Jun at U$15.8mn (month-to-date (27 Jun)). Positive external balance supports VND could contribute to the resilience of the VND vs. the trading partners.

- **Growth and Inflation Outlook:** Markit reported another strong print for the manufacturing sector at 53.9 vs. the previous 52.7. According to the respondents, there has been the fastest rise in new business since Mar 2017 and there were also strong gains in output and employment. Cost inflation accelerates but output price only rose marginally and that seems to signal strong industrial production. The survey report also indicated that the higher new orders contribute to an increase in backlogs of work. Industrial production indeed accelerated to 12.3%y/y from previous 7.1%, underpinned by solid growth in the manufacturing sector that outweighed the slowdown in the electricity and the decline in mining & quarry.

- Retail sales for the first half of the year also picked pace to 10.7%y/y from 10.1% in the first five months. The headline was underpinned by trade, hotel and restaurant as well as services. Tourism spending seems to have weakened in Jun but we expect that to improve as dong has depreciated significantly.

- As a result, growth for the first half of the year exceeded expectations at 7.08%y/y. 1Q GDP rose 6.8%y/y slowing from the previous 7.38%. The quarter saw broad slowdown in various sectors including agriculture, manufacturing and services industry.

- CPI surprised to the upside again with a print of 4.35%y/y vs. the previous 3.86%. Food costs actually accelerated in the month along with transportation.

- Back in May, Deputy Premier Trinh Dinh Dung said that Vietnam has decided to restructure the industry sector such that the industry and construction sectors could represent 30-35% of GDP by 2020 instead of the originally set 42-43%. Beyond 2020 to 2025, the industry sectors should be maintained at over 35% of GDP. This could mean a more diversified economy.

- **Monetary Policy Forecast:** Interbank rates fell to a year low in the past month before rebounding into the last week. At this point where domestic growth is rather strong and Vietnam is vulnerable to external headwinds, we do not see much reason for SBV to cut rates as inflation has repeatedly surprised to the upside. With VND still likely to weaken, SBV is likely to keep monetary policy stance unchanged. The sharp depreciation that we see in RMB has swung the VND NEER higher but gains may still be capped. We anticipate that SBV could continue to keep this VND weak against other trading partners to boost trade as well as to attract foreign direct investment into the country.

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

- Current account recorded an increase in the current account at USD3.9bn in 1Q this year, from the previous U$3.0bn. This data comes from narrower trade deficit of services of U$391mn (vs. prev. -U$1.042bn). Net trade surplus of goods only narrowed slightly to U$4.86bn from previous U$4.93bn. The competitive dong could keep the current account in surplus.

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

FX Forecasts

	End Q3-18	End Q4-18	End Q1-19	End Q2-19
USD/JPY	109	108	107	107
EUR/USD	1.1700	1.2000	1.2200	1.2300
GBP/USD	1.3400	1.3800	1.4000	1.4200
AUD/USD	0.7400	0.7500	0.7800	0.8000
NZD/USD	0.6700	0.7000	0.7100	0.7200
USD/SGD	1.3750	1.3650	1.3600	1.3550
USD/MYR	4.0800	4.0300	3.9800	3.9800
USD/IDR	14450	14250	14100	13900
USD/THB	33.50	33.80	33.80	33.30
USD/PHP	54.00	53.50	54.00	53.80
USD/CNY	6.75	6.72	6.65	6.62
USD/HKD	7.85	7.85	7.80	7.80
USD/TWD	30.80	30.60	30.50	30.40
USD/KRW	1130	1110	1100	1090
USD/INR	70.00	69.00	68.50	68.20
USD/VND	23100	23000	22900	22800
DXY Index	94.31	92.20	90.79	90.18
SGD Crosses	End Q3-18	End Q4-18	End Q1-19	End Q2-19
SGD/MYR	2.9673	2.9524	2.9265	2.9373
SGD/IDR	10509	10440	10368	10258
SGD/THB	24.36	24.76	24.85	24.58
SGD/PHP	39.27	39.19	39.71	39.70
SGD/CNY	4.91	4.92	4.89	4.89
SGD/HKD	5.71	5.75	5.74	5.76
SGD/TWD	22.40	22.42	22.43	22.44
SGD/KRW	822	813	809	804
SGD/INR	50.91	50.55	50.37	50.33
MYR Crosses	End Q3-18	End Q4-18	End Q1-19	End Q2-19
EUR/MYR	4.77	4.84	4.86	4.90
JPY/MYR	3.74	3.73	3.72	3.72
MYR/HKD	1.92	1.95	1.96	1.96
MYR/CNY	1.65	1.67	1.67	1.66
GBP/MYR	5.47	5.56	5.57	5.65
AUD/MYR	3.02	3.02	3.10	3.18
NZD/MYR	2.73	2.82	2.83	2.87
MYR/IDR	3541.67	3535.98	3542.71	3492.46
MYR/INR	17.16	17.12	17.21	17.14
MYR/KRW	276.96	275.43	276.38	273.87
MYR/PHP	13.24	13.28	13.57	13.52
CNY/MYR	0.6044	0.5997	0.5985	0.6012

Source: Maybank FX Research as of 29 Jun 2018

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

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