Maybank

FX Monthly

2018, Issue 7: Opportunities in Trade War Environment

What Has Changed This Month?

- We revised GBP and JPY currency forecasts lower against the USD. GBP forecasts were revised lower to take into consideration the challenging process to forge a united stance within the UK parliament on Brexit amid Brexit time decay and the potential delayed progress towards negotiating with the EU. The downward revision to the JPY forecast reflects not only the monetary policy divergence but also the loss in appeal as safe haven proxy due to trade war dynamics.

Our Strategies

- We expect the USD 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.

- Our study on sensitivity of APAC FX to movements in Renminbi (proxied by CNH) and risk sentiment (proxied by MSCI World Index) using daily change data YTD 27 Jul 2018, showed that KRW, AUD and NZD are the most sensitive amongst APAC FX to changes in CNH and equities. We caution that (1) trade war is far from over and the US is building allies, (2) another possible RRR cut is RMB negative. So, we anticipate that more weakness could still be possible for the RMB especially within this quarter before a possible recovery into the next quarter. We caution that this could translate to potential downside risks for KRW, AUD and NZD.

- Monetary policy convergence is still a theme to strategically position for ahead of the turn of the year. 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. In particular, we favour positioning ahead for ECB-Fed policy convergence, given that Fed tightening (2 more this year and another 2 or 3 hikes next year) may already be priced in while markets may potentially run the risk of “under-expecting” ECB’s future policy normalisation trajectory.

- We see chance for relative plays for Aug: selected EM FX such as PHP, INR, IDR to recover in the near term, given excessive selling due to EM vulnerabilities (twin deficits) in the past 2 - 3 months while trade-war sensitive currencies such as KRW, CNH, SGD, MYR, THB could remain soft.

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FX Forecast Revision

Upward	Downward
--	GBP, JPY

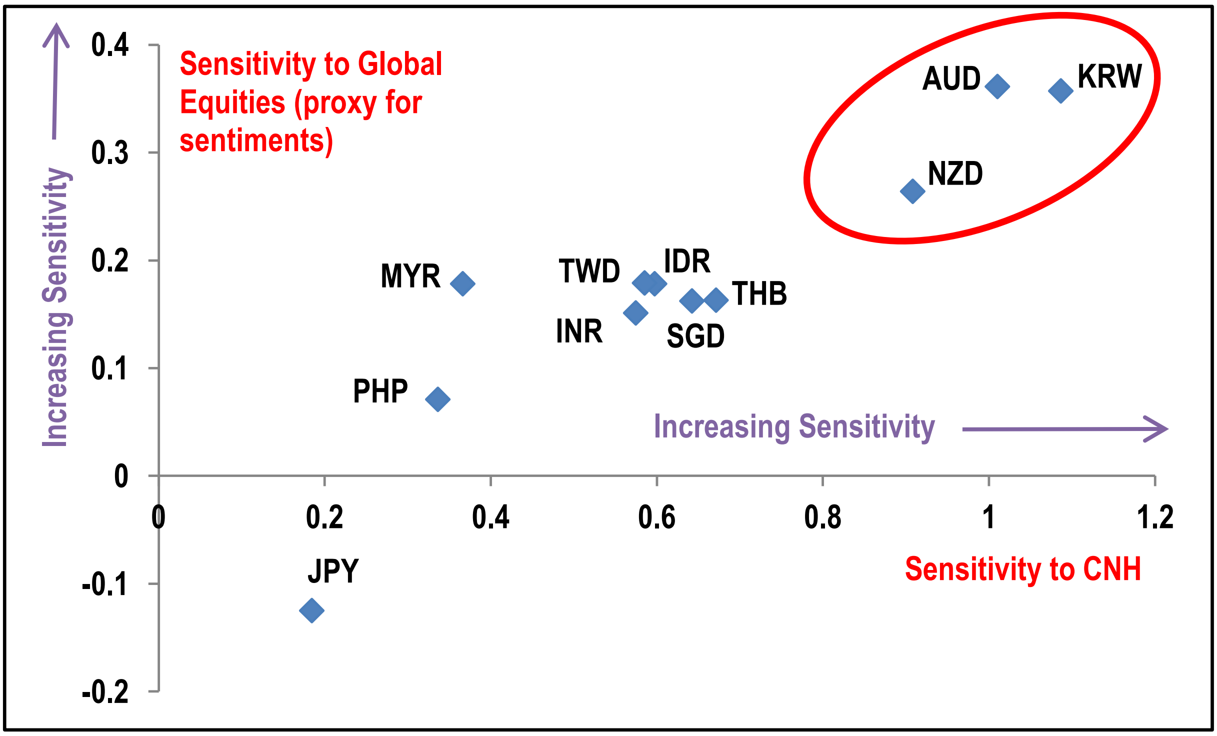
Top 3 Currency Plays for August

- Bias to Buy EUR on dips towards 1.14-1.15 levels for move towards 1.25
- Accumulate USD, EUR against AXJ FX
- Long basket of PHP, INR, IDR vs short basket of KRW, CNH, SGD, THB

Key Events for the Month Ahead

Date	Event
4-10 Aug	Nomination for Indonesian Presidential Elections
16 Aug	Indonesia President Speech to the Nation and Delivery of the 2019 State Budget Speech to Parliament
20 - 23 Aug	US public hearings on another round of tariffs on $200bn imports from China
31 Aug	Potential Implementation of additional tariffs on imports from China

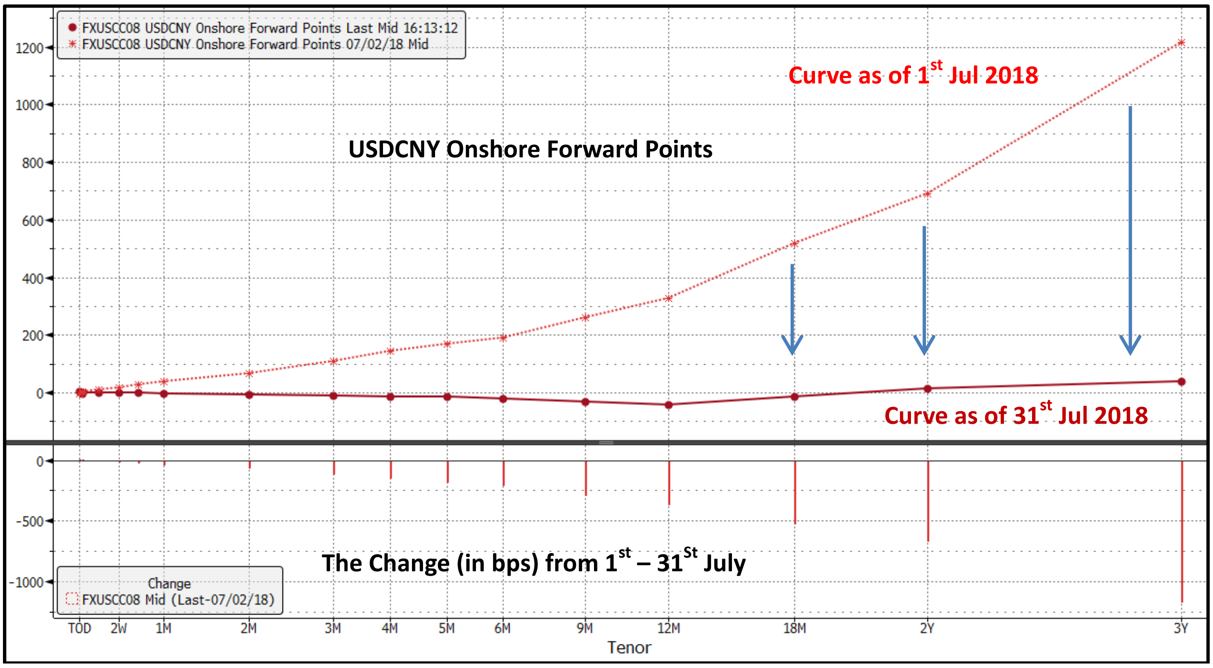
KRW, AUD, NZD are the most sensitive to CNH moves and Global Sentiment Shifts



Note: Note: Beta of XXX/USD to CNH as independent variable for both charts; Chart on left: Y axis – Beta of XXX/USD to MSCI World Index as independent variable based on daily change data (YTD: 12 Jul 2018), Chart on right: Beta of XXX/USD to USD 3-month LIBOR as independent variable based on daily change data (YTD: 12 Jul 2018)

Source: Bloomberg, Maybank FX Research & Strategy

USDCNY Spot Could Ease Eventually. Forward Points Have Fallen in Recent Weeks and even turned negative for 6M-18M tenors. This could sustain for much of Aug as the trade war remains at its most intense.



Source: Bloomberg, Maybank FX Research & Strategy

G7 Global Overview

USD: Trade Tensions Still Centre Stage

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USD Index	95.21 (94.31)	92.77 (92.20)	91.77 (90.79)	91.06 (90.18)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The USD index went slightly higher in our forecast horizon due to downward revisions to GBP (due to rising risk of leadership challenge of PM May in 3Q 2018 and potential delayed progress in negotiations with EU leading to volatility in run up to 1Q 2019) and JPY (i.e. safe haven plays did not materialize as USD became safe haven of choice).

- 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:** The US economy accelerated to a 4.1% growth in 2Q. The annualized rate of gains in GDP was short of the 4.2% median consensus forecast. It followed 1Q growth of 2.2% that was revised from 2%. Consumer spending grew 4%, more than estimated, while nonresidential business investment climbed at 7.3%.

- US CPI rose less than expected in June amid falling utility prices and a record decline in hotel costs, even as the broader trend showed a pickup in annual inflation. The CPI rose 0.1% from the prior month after a 0.2% gain in May, while the gauge excluding food and energy costs rose 0.2%. This survey consensus median was expecting a 0.2% gain in both the main and core indexes. The overall CPI YoY rose 2.9%, while the core CPI rose 2.3%, both in line with expectations. The pickup in core inflation reflects continued upward pressure on services and some goods, with job gains and consumer spending steady and second-quarter economic growth projected to temporarily accelerate to 4%. We expect inflationary pressures to pick up as corporates may be looking for ways to pass along higher production costs to customers as fuel and transportation prices rise and tariffs provide a boost.

- Meanwhile average hourly earnings, adjusted for inflation, were unchanged on an annual basis for a second month. Wages, which feed into inflation pressures, remain weaker than economists had expected at this point in a tight job market.

- **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 Aug 2018:** ISM Mfg (1 Aug); FOMC (2 Aug); FOMC meeting minutes (23 Aug); Factory orders and Durable Goods Orders (2, 24 Aug), NFP (3 Aug); Trade balance (6 Jul); CPI (10 Aug); Retail Sales (15 Aug); Housing Starts (16 Aug); GDP 2QS (29 Aug); Core PCE (30 Aug); PCE Deflator (30 Aug).

- **Technical Outlook:** Our call (in last month's FX Outlook) for limited upside for the USD and our bias to lean against strength panned out well in Jul. DXY traded high of 95.65 (19 Jul) before easing lower. Last seen at 94.40 levels. Bullish momentum on weekly chart is waning while stochastics is falling from overbought conditions. Bearish momentum on daily chart is at risk of accelerating. 21 DMA looks on track to cut 50 DMA to the downside - short term bearish signal potentially forming. We maintain our bias for downside play. Key support at 94 levels (23.6% fibo retracement of Apr low to Jun high). An extended move lower towards 93.12 (38.2% fibo) should not be ruled out. Resistance at 95, 95.50 (triple top).

EUR: From Policy Divergence to Policy Convergence Soon

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

No Change to Previous Forecast

- **Motivation for the FX View:** In the near term (next few weeks) we do not rule out EUR overshooting our 3Q forecast to the upside 1.1850 - 1.1910 levels. CME non-commercial futures positioning report showed EUR-longs have unwound and long positions in EUR was at 14-month low. We believe stale EUR-longs may have been flushed and fresh EUR-longs may start to rebuild at relatively attractive levels (as EUR has corrected lower by nearly 7% from 2018-high) and this should see EUR strengthen ahead. Interim support at 1.15 – 1.16 should continue to hold. We reiterate our bias to accumulate on dips.

- **We hold to our constructive outlook on EUR and maintain a bias to accumulate EUR on dips** 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) improved economic backdrop on sustained signs of activity momentum in Europe, looking past transitory factors in 1Q and trade war affecting business sentiment; (3) inflation could remain supported or at risk of overshooting ECB’s target due to energy prices and via import price channel; (4) political risks to gradually recede (German Bavarian state election on 14 Oct a risk to watch); (5) easing trade tensions between US and EU, following Trump-Juncker meeting. These factors formed the basis of our upward sloping trajectory over the next 12 months. In addition, ECB Draghi’s term as ECB President ends sometime in 4Q 2019 and the talk about Bundesbank President Weidmann (ECB front-runner and long-time critic of ECB’s ultra-loose policies whom could push for faster pace of policy normalisation) possibly succeeding Draghi could quietly and gradually brew the upward pressure for EUR. We favour positioning ahead for ECB-Fed policy convergence at some stage, given that Fed tightening (2 more this year and another 2 or 3 hikes next year) may already be priced in while markets run the risk of “under-expecting” the ECB’s future policy normalisation trajectory.

- While Draghi may wish to keep rates on hold during his tenor as ECB President, he sounded rather confident in the assessment of Euro-area growth and inflation (26 Jul). He said that “domestic cost pressures are strengthening and broadening amid high levels of capacity utilization and tightening labor markets”. He also played up the recent trade talks (25 Jul) between Trump and EU Commission President Juncker as positive step to defuse trade tensions. Basically Trump and Juncker agreed to suspend new trade tariffs while negotiating over trade (re-examine US steel and aluminium tariffs and tit-for-tat tariff response from EU). Planned 25% tariffs on autos are on hold (relief for Euro autos such as Daimler, BNM, Volkswagen, etc.)as Juncker said in a press conference with Trump that no other tariffs would be introduced as long as they are in negotiations. According to Bloomberg news, the leaders pledged to expand European imports of US LNG and soybeans and both agreed to work together toward zero tariff.

- **Growth and Inflation Outlook: Advanced estimate of 2Q GDP will be released on 31 Jul. Survey and activity indicators in the past few months suggest that growth for 2Q could well hold up.** Industrial production rebounded to +2.4% y/y in May (vs. +1.7% in Apr); preliminary Mfg PMI picked up pace to 55.1 in Jul (54.9 prior) though prelim services PMI slipped to 54.4 in Jul (vs. 55.2 prior). Taking stock, 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 8.4% (May) is now at its lowest level since Dec-2008. Nonetheless, Euro-area recovery continues with 20 consecutive quarters of growth.

- The last ECB macroeconomic projection in Jun 2018 report shows that 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). 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.

- Last ECB macroeconomic projection (Jun 2018) shows 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 inched higher to 2% y/y in Jun (vs. +1.9% in May)** while core inflation slipped modestly to 0.9% (vs. 1% in May). 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 rise towards ECB's 2% target on ECB's monetary policy measures, continuing economic expansion and rising wage growth. Average earnings growth also ticked higher to +1.96% in 1Q, its highest level since 2Q 2016. Wage growth is expected to rise further amid tightening of labour market in Euro-area.

- **Monetary Policy Forecast: There is no Governing Council meeting scheduled for Aug. The next ECB meeting is scheduled to be on 13th**

Sep and we expect ECB to keep monetary policy stance status quo following their move in Jun on timeline of APP reduction and forward guidance on rates. **While ECB may hope to keep rates unchanged till Autumn 2019 (around Oct-Nov), we see risk that the ECB may need to move earlier than expected** (relative to ECB's timeline) 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 Euro-area inflation to overshoot ECB's inflation forecast in the near term. A weaker currency could result in higher prices via the **import price channel**. This may well add on to further upside pressure for Euro-area 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.

- At the last ECB meeting (26 Jul), ECB's Draghi offered no new insights to forward guidance. He reiterated that "key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term". He seemed to exhibit more confidence in the growth assessment and prospect for sustainable convergence of inflation to ECB's target. On inflation, Draghi said that "domestic cost pressures are strengthening and broadening amid high levels of capacity utilization and tightening labor markets". Although he did repeat his warning that increased protectionism around the world could hurt euro-area exports and undermine growth recovery in euro-zone, he seemed less concerned as he played up recent Trump-Juncker efforts to ease trade tensions. He added that the ECB has not done further analysis and had not updated its estimate of the impact of protectionism on Euro-area growth… direct impact of the tariffs implemented are limited but full trade war would create an entirely different climate.

- Taking stock of ECB action in 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 further to 38-month low of EUR22.4bn in May, from EUR29.5bn in Apr. Decline was due to falling surpluses on trade in goods and services as well as primary income. Current account surplus to GDP was last seen at 3.6%, for the 12-months to May.

- 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:** Jul Mfg PMI (1 Aug); Jun PPI (2 Aug); Jul services PMI, Jun retail sales (3 Aug); Jun IP, 2Q prelim GDP, Aug ZEW survey expectations (14 Aug); Jun trade (16 Aug); Jun current account, Jul CPI (17 Aug); Jun construction output (20 Aug); Aug prelim PMIs and consumer confidence (23 Aug).

- **Technical Outlook:** Our call (in last month's FX Outlook) for interim bottom for the EUR around 1.15 levels and bias to buy on dips materialized. Pair was last seen around 1.17 levels (as of writing). On the weekly charts, bearish momentum is waning while stochastics has risen from oversold conditions. On the daily chart, mild bullish momentum remains intact while 21DMA cuts 50DMA to the upside – an indication of bullish signal in the near term. All these signals suggest room for further upside for the EUR. In the near term (next few weeks) we do not rule out EUR trading higher. Key resistance at 1.1760 (23.6% fibo retracement of 2018 high to low). Decisive break above this puts next level at 1.1850, 1.1910 levels. Interim support at 1.15 – 1.16 should continue to hold. We reiterate our bias to accumulate on dips.

GBP: Chequers Deal No Silver Bullet but a Positive Start

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
GBPUSD	**1.3200** (1.3400)	**1.3700** (1.3800)	**1.3400** (1.4000)	**1.3700** (1.4200)

Previous Forecast in Parenthesis

- **Motivation for the FX View**: GBP may see some near term support as we enter into August, in anticipation of 25bps rate hike by BoE at the upcoming MPC meeting (2 Aug). An environment of possibly lesser brexit-related negative headlines this summer amid UK parliament in summer recess (till 4 Sep) and PM May taking control of Brexit negotiations (lesser in-cohesiveness as hard Brexiters' voice are temporarily suppressed) may help to curb volatility and partially mitigate GBP negativity (due to uncertainties associated with Brexit and PM May's leadership). The recent Chequers deal (6 Jul) and White Paper (12 Jul) was a positive start but is by no means a silver bullet. There are plenty of disagreements that need to be ironed out. We **believe some of the "ideal plans" would need to be re-discussed and amended to comply with EU rules and satisfy the divisions within the parliament. And this process amid brexit time decay** (7-8 months remaining to exit on 29th Mar 2019) **would remain a source of volatility for the GBP.** In light of recent development and to reflect the challenges coming up, we revised lower our GBP forecasts.

- **Recent Brexit Development**: The Chequers deal (6 Jul), followed by White Paper (12 Jul) were the latest proposal from PM May. It is more definitive (and a good start, in our opinion) in terms of stated preferences but is by no means the final ultimatum for exit as it has since attracted multiple criticisms from within her party and people and from EU Chief Negotiator Barnier, whom have already rejected the White paper proposal on customs arrangement. 10 resignations from PM May's Conservative parties including 4 Ministers reinforced growing divide with her party and raises the likelihood of PM May's leadership being challenged.

- Chequers deal came into prominence on 6th Jul after PM May achieved a rare consensus in a key cabinet meeting at the Prime Minister's private country retreat at Chequers Court. The Cabinet Ministers then agreed to a Free Trade Area (FTA) for goods (but not services) between UK and the EU, in effect continues the existing regulatory and customs arrangement for agricultural and manufacturing goods after Brexit. This arrangement would allow the UK to set and collect its own tariffs and also collect EU tariffs on goods moving through Britain to the EU, and in turn pass the tariff collected to Brussels.
- The White Paper was published less than a week later (on 12th Jul) to set out the proposal in slightly greater detail, which we believe would be subjected to amendments. Some of the highlights include: (1) Taking the UK out of Single Market[1] and the Customs Union[2]; (2) New FTA for goods but "regulatory freedom" for digital and services (i.e. banking) sector; (3) UK to be able to strike new trade deals around the world; (4) Avoid hard border between Northern Ireland (UK sovereignty) and Ireland (EU autonomy); (5) End annual contribution to EU budget; (6) UK to be under some EU laws till end of transition period (end-2020).
    - EU chief negotiator Barnier has rejected UK's White Paper proposal on customs (27 Jul). He said that the "EU cannot and will not delegate the application of its customs policy, of its rules, VAT and excise duty collections to a non-member who would not be subject to the EU's governance structures".
- PM May announced (24 Jul) that she is taking control over UK's brexit negotiations. She will tap on Chief Europe adviser Oliver Robbins, whom will deputise PM May. Brexit ministry may seem to have side-lined as cabinet office will have overall responsibility for the preparation and conduct of the negotiations.
- 10 MPs, including 4 Ministers (Former Brexit Ministers David Davis and Steve Baker, Foreign Secretary Boris Johnson and Defence Minister Guto Bebb) reinforced growing divide within

[1] Refers to the European Single market is an economic arrangement between E.U. member states and a few others who agree to four fundamental freedoms: the free movement of services, goods, capital and people.

[2] The customs union ensures E.U. member states and others each charge the same import duties on goods from countries outside the bloc. Membership also allows countries to enjoy tariff-free goods transport.

PM May's Conservative party members and raises the likelihood of PM May's leadership being challenged. And there are already talks of a vote of no confidence in PM May (which led to speculation that PM May is considering extending the summer recess till Oct instead of scheduled 4th Sep) – which we do not rule out. Speculation on this is yet another source of volatility for GBP.

  - 48 of her lawmakers' signatures would be required to prompt a confidence vote in parliament (and subsequently 159 out of 316 Conservative votes are required to remove PM May) or if 3 Conservative members declare they have no confidence in the government and invite the opposition (Labour party) to call a formal vote (a toxic option to bring down the government as current ruling Conservative party could end up losing the election due to growing divide internally).

- There are also talks of another General Election or even a second Brexit referendum (to vote on Soft Brexit, Hard Brexit or Remain in EU). We do not expect a GE this year and do not expect a second referendum to be allowed.

- **Forecast Change and a Slight Kink in Trajectory:** Given recent development in Brexit, including the resignation of high profile Ministers, we calibrated the 3Q forecast lower to factor in the risk of PM May's leadership possibly being challenged in the lead up to the Conservative Party Conference (30 Sep – 3 Oct 2018). News flow of party members calling for vote of no confidence could add to downside pressure for the GBP even though our base line scenario is that PM May remains in power for this year as we do not see any candidate whom can unite the divisions with PM May's party (given that a slight majority seem biased for soft brexit) at the moment. We maintain an upward trajectory of our GBP forecast to reflect our cautious optimism of an orderly Brexit but kinked our 1Q 2018 forecast lower to account for the potential uncertainty (resulting in GBP weakness) leading into formal exit (29 Mar 2019, 11pm GMT). Finally, though we maintain an upward trajectory of our GBP forecast, we revised lower the forecast to take into consideration the challenging process (source of volatility for GBP) to forge a united stance within the UK parliament on Brexit amid Brexit time decay and the potential delayed progress towards negotiating with the EU.

- Into the medium term, we maintain our bias that GBP could trade higher from current levels of 1.30-1.31. GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40 – 1.45). The 20% or so depreciation in the Brexit-aftermath (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 final GDP growth was revised slightly higher to +0.2% q/q (vs. +0.1% advanced estimate vs. +0.4% in 4Q 2017).** The upward revision was due to net trade (which made a modest +0.1% contribution to growth. Nonetheless 1Q growth data slowed to weakest level since 2012 and it 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 – retail sales, manufacturing, services and construction PMIS rebounded - should bode well for 2Q GDP (preliminary data to be released on 10 Aug).

- The next Quarterly Inflation Report (to be released on 2 Aug) would be of interest for guidance on growth, inflation and rates outlook. In the last BoE's QIR (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 continued to hold steady at 1y low of 2.4% y/y in Jun. That was the 3rd consecutive month that inflation held steady.** Prices of clothing and footwear as well as computer games fell but the decline was offset by increase in petrol and household energy prices. 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 slipped to 1.9% y/y in Jun (vs. 2.1% y/y in May).

- **Monetary Policy Forecast:** We maintain our long-held view (which previously was out of consensus but now-turned consensus) that the BoE will deliver a 25bps hike to bring policy rate up to 0.75% as activity momentum remains intact (poor 1Q activity was due to bad weather) while labor market remains tight, with unemployment rate at 43Y low. Wage growth could re-accelerate as public sector salary cap may be lifted. Times reported that PM May is planning to announce that state-employed staff including teachers, doctors and police officers could get a pay rise this year as government's pay cap (at 1%) could be lifted. Markets have re-priced the odds of a 25bps rate hike to 0.75%. OIS-futures implied a nearly 80% chance of rate hike at the upcoming meeting (up from under 50% in mid-Jun). 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 further to -3.4% of GDP for 1Q 2018 (from -3.8% of GDP in 4Q 2017). This represents the 4th consecutive quarters of improvement and is the narrowest level since 2011, helped by narrowing of trade (in particular goods exports was strong) and primary income deficits. 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:** Jul Mfg PMI (1 Aug); Jul Construction PMI; BoE MPC meeting and QIR report (2 Aug); Jul services PMI (3 Aug); Jun trade, IP, construction output, 2Q GDP (10 Aug); Jun labor report (14 Aug); Jul inflation (15 Aug); Jul retail sales (16 Aug); Jul public finances (21 Aug).

- **Technical Outlook:** The magnitude of GBP's decline since Apr moderated this month (Jul). Pair was last seen at 1.3130 levels. Mild bullish momentum was seen on daily chart but lacks a strong conviction. On the weekly chart, bearish momentum is waning while stochastics is rising from oversold conditions. These could be supportive of GBP strength. Key resistance at 1.3170/80 levels (21 DMA) needs to be broken for further upside to gather traction towards 1.3240 (50 DMA), 1.3320, 1.3460 levels. We are biased for mild upside play. Support at 1.3060 and 1.3010 (interim double bottom). Caution that a decisive break below the interim double bottom could see the pair test 1.29 on the downside.

AUD: The War Matters

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

No Change to Previous Forecast

- **Motivation for the FX View:** The ramifications of the US-China trade war have started to show up in the base metal prices, in particular, copper prices. The fall in these prices drags on the AUD. With this trade war still far from over and rather harsh verbal exchanges seen recently, we look for the AUD to remain under pressure for much of this quarter.

- Apart from being a risk-sensitive and China-exposed currency, the US-China trade war also has a concomitant effect of delaying rate hikes. 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.

  At the recent by-elections, the Coalition lost all three seats it contested to the Australian Federal Labor party. That was taken as a sign of a rejection on its recent corporate tax cuts policies which the labour party had been most outspoken against. The odds of a re-election win have deteriorated for the coalition and as what we have seen in the past, there could be a chance of a hung parliament. Election timings are called by the PM and he had sworn to serve a full term. The next half-Senate election must be held between August 4, 2018 and May 18, 2019. The House of Representatives election date, on the other hand, can be set any time up until November 2, 2019. Key for Australia is the ability of the government to improve or worsen the budget deficit. None of the government (Labour or Coalition) have managed to improve or worsen the budget deficit to the point that changes the credit rating outlook for the past few years. Hence, we think impact on AUD from a Labour win or Coalition or Liberal win is likely to be rather neutral. A hung parliament occurs when none of the political party could get an outright majority and that requires securing 76 seats in the 150 members of the House of Representative. That could see a greater chance of some volatility at that point but hung parliaments do not last long and that suggests that pressure on AUD will also be temporary.

- 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. View for AUD in the next 1 month is for it to remain within the 0.73-0.76 range vs. the USD. Next 3 months should see price pressure to pick up pace and AUD to head higher to around 0.75-0.77 range. We anticipate more market players to start pricing in an RBA hike at the turn of the year for a Feb hike that could keep AUD elevated at around 0.78 into Mar next year. Look for an eventual move higher towards 0.80 by Jun next year.

- **Growth and Inflation Outlook:**
  - **CPI** was the most widely watched release for the month (given that it is a quarterly release) and there was a slight build-up in expectations for inflation to pick pace in 2Q. The headline figure did quicken but not as much as the expected 2.2%y/y. CPI quickened to 2.1%y/y from previous 1.9%. The average of the trimmed mean and median was at 1.9%. Seasonally adjusted, the headline actually firmed to 2.2%y/y from previous 2.0%. Food inflation softened in the quarter but this was outweighed by the acceleration in transportation, recreation and education. Looking at the breakdown for goods and services, the CPI for goods seem to be on the uptick, possibly buoyed by the rise in energy prices as well as the AUD.
  - **Growth** prospect is rather decent, notwithstanding the external headwinds posed by the trade war. NAB business surveys point to rather strong business conditions and resilient business confidence. Westpac consumer confidence surged 3.9%m/m in Jul to 106.1. However, these corporate and consumer confidence have not really translate into stronger activity yet. Hiring momentum rose which could support private consumption but much of the hiring momentum for Jun was part-time rather than full-time. Retail sales growth (seasonally adjusted) remained rather subdued, at around 2.5%y/y (s/adj) in May vs. previous 2.7%. Although only a proxy for household spending, the high level of household debt does crimp on private consumption. While RBA has kept rates unchanged for the past several quarters, housing interest to household disposable income crept higher to 7.39% from

previous 7.26%. This print could have headed higher given the rise in the bank bill short-term rates have soared above the 2.1% at one point in Jun vs. sub-1.8% level in Jan. In the meantime, capital spending seems to have been on the upmove for sectors apart from manufacturing and mining into 1Q 2018. We look for 2Q CAPEX which is out on 30th Aug to have a better idea of the economic rebalancing. In addition, capacity utilization rate remains rather high compared to historical standards.

- **Monetary Policy Forecast:** We continue to expect RBA to keep cash target rates unchanged. With the CPI still close to the lower bound of the 2-3% inflation target and plenty of uncertainty in the horizon amid the current trade war, there is very little motivation for the central bank to move rates at this point. AUD has been under pressure against the USD, trapped in a downward sloping trend channel. However, against major trading partners, the TWI has appreciated since the mid of Jun. This move higher against trading partners could further discourage the RBA from signaling any change in policy in the horizon. The central bank has clearly indicated that a cheaper AUD is a better AUD and every meeting is merely a chance to reiterate that.

- 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. Monetary policy divergence vis a vis most of DMs (except BOJ) could continue to weigh on the AUDUSD. We no longer look for RBA to hike until early next year (still earlier than 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:** Trade on 2nd Aug, retail sales on on 3rd; RBA policy meeting on the 7th; home loans on 8th; SomP on 10th; NAB business survey on 14th; wage price index for 2Q on 15th; labour report on 16th; Minutes of the meeting on 21st; 2Q Capex and building approvals for Jul on 30th; private sector credit on 31st.

- **Technical Outlook:** AUDUSD was last seen around the 0.74-figure. The double bottom price pattern formed at around 0.7310 is taking its time to play out. In an environment of a USD correction (lower), AUDUSD may have a chance to test the 0.75-figure. The number of net non-commercial futures positions for the AUD was seen at -45.5K, the lowest Dec 2015. We do not see this as sustainable but recovery is not expected to be sharp as well given trade war risks. Eye the 0.7480 (upper bound of trend channel)/0.75-figure for signs of a breakout in the near term).

NZD: Short Positions Overstretched while Dairy May Surprise

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

No Change to Previous Forecast

- **Motivation for the FX View:** We see rising risks that NZD could rebound from current levels (0.6790) as NZD shorts positions reached unprecedented levels and that dairy prices may stage a comeback this summer. Nonetheless we expect the trading range to remain confined in the range of 0.67 – 0.6950 for the month ahead as the Kiwi still lack fundamental catalysts to drive it meaningfully higher as trade war tensions between US-China remains (relative high sensitivity to movements in CNH and risk sentiment amongst G7s) and monetary policy divergence between Fed and RBNZ persists.

- Adding to this, we think that some of the positive contributing factors for USD strength have been priced in (US data outperformance, Fed rate hike expectations this year and trade war risks with China), and there are **rising risks that USD strength could waver** in the weeks ahead. Given the possibility of USD strength easing, we expect to see relief rally in the NZD but strength may not be sustained as NZD still lack catalysts from within (unless dairy prices turned higher) and the external environment remains unfavorable (concerns of trade wars inflicting damage to world trade and world growth could hamper a meaningful recovery in the Kiwi).

- GDT auctions (7 and 21 Aug) will be closely watched given some divergence between dairy market prices (4 consecutive sessions of decline in dairy prices since Jun’s auction) and payout forecast (Fonterra upgraded farmgate milk prices to $7/kg for 2018/19). Movements in dairy prices will impact the NZD, given its strong positive correction. Dry weather conditions (due to Summer) in the Northern hemisphere could result in lower supply in coming months while previous auctions (although prices fell) saw no decline in demand from Chinese buyers. These factors may be supportive of dairy prices and could even support the case for NZD upside.

- RBNZ MPC meeting and the release of quarterly Monetary Policy Statement (9 Aug) will also be keenly watched, especially after the recent slippage in both services and manufacturing PMIs as well as the surprised rebound in inflation. In particular we will be watching for potential wordings change in the MPS in relation to “above-trend pace of growth” and if RBNZ Governor Orr acknowledges the recent decline in Kiwi and if he flags the possibility of higher price pressures amid higher energy prices.

- **Growth and Inflation Outlook:** Growth for 2018 is likely to continue at current pace of around 3%, supported by net immigration, fiscal stimulus amid accommodative monetary policy. **2Q GDP data is scheduled for release on 20th Sep.** 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. Manufacturing PMI moderated to 52.8 in Jun (vs. 54.4 in prior month) while services PMI fell sharply to 5.5 year low of 52.8 (vs. 57.1 in May). Given that services sector account for 2/3 of NZ GDP, this sharp decline may be of concern for 2Q GDP.

- The next quarterly Monetary Policy Statement (MPS) will be released on 9 Aug. The last MPS (10th May) 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. We will be watching for potential wordings change in relation to “above-trend pace of growth”. For inflation, 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.

- **2Q CPI rose to 1.5% y/y, from 18-month low of 1.1% in 1Q.** The rise was due to higher prices for household energy (subcomponents including electricity, gas and solid fuels), transport (higher petrol prices), food, actual rentals and dwelling insurance. Both tradables and non-tradable inflation rose in 2Q after a short divergence (tradables lower vs. non-tradables higher) in 1Q. 2Q headline CPI now comes close to the middle of RBNZ’s inflation target range of 1 – 3%. Our internal projection also shows inflation possibly 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.

- **Monetary Policy Forecast:** We still expect RBNZ maintain OCR on hold at 1.75% at its next meeting (9th Aug) amid cautious inflation outlook (but we expect an eventual move higher to 2% in early 2019), signs of moderation in global activity and ongoing trade war concerns between US and China. 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), those comments seemed to suggest that **easy monetary conditions could stay on for longer**. We still **hold to our more than optimistic view (compared to street estimate) for RBNZ rate hike in 2Q-3Q 2019.** We still expect inflation to pick up, owing to fiscal impulse, higher prices via import price channel given the depreciation in NZD, higher oil prices and minimum wage increases.

- 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.

- **Latest Fiscal and External Balance Outlook:** NZ government's operating surplus continues to surprise to the upside. Operating surplus was 5.23bn (9% above forecast) for 11 months to May. 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:** 2Q Labour report (1 Aug); 2Y inflation expectation (8 Aug); RBNZ MPC (9 Aug); Jul Mfg PMI (10 Aug); Services PMI (13 Aug); Food prices (13 Aug); 2Q PPI (17 Aug); 2Q retail sales (22 Aug); Jul trade (24 Aug); Aug Activity outlook (31 Aug). GDT trade auctions take place on 7 and 21 Aug.

Technical Outlook: Our caution in last month's FX Outlook calling for rebound risks in range of 0.67 – 0.69 played out, as we write. Pair was last seen at 0.6830 levels, after trading an intra-month low of 0.6714 (19 Jul). Bearish momentum on weekly chart is waning while stochastics is rising from oversold conditions. On the daily chart bullish momentum remains intact while stochastics is rising into overbought conditions. Technical indicators suggest further rebound risks especially on break above 0.6830, 0.6870 (50 DMA). An extended move higher towards 0.6920 (61.8% fibo) cannot be ruled out. Support at 0.6790 (21 DMA), 0.6740 (upward sloping trend-line support from the low in Jun and Jul) before 0.6690 (Jul low). Look for 0.6750 – 0.6920 range next month.

JPY: Weighed By BOJ Policy Decision

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDJPY	115.00 (109.00)	112.00 (108.00)	111.00 (107.00)	111.00 (107.00)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** JPY weakness in Jul looks almost certain to extend into Aug. The JPY had at one point slipped to the 113.17-level (on 19 Jul), just a tad off the 2018 high of 113.39 amid USD strength. But a mix of market expectations over BOJ policy and USD weakness has allowed the JPY to shake off most of this weakness. The JPY has since strengthened to around the 110-levels at the point of writing. This JPY strength though is unlikely to persist as BOJ is expected to stay the course on its ultra-easy monetary policy and USD strength still has some legs. Instead, there is room for the JPY to move lower in the next three months. Consequently, we have revised our USDJPY forecast higher but maintain the pair's downward trajectory.

- The recent gains in the JPY are attributable to speculation that the BOJ would tweak its massive stimulus programme, particularly its control of the 10Y JGB yield around zero percent. Market is speculating that the BOJ will reduce the negative impact that low yields are having on the profitability of commercial banks. The jump in 10Y JGB yield to levels not seen since Feb 2017 and at 2018 high of 0.113% levels on 27 Jul had prompted the central bank to offer to buy unlimited amount of bond twice to temper the yield increase. While 10Y JGB has eased from that high, it remained elevated compared to the 0.02-0.05% levels it had been hovering around for the past few months. The spike in 10Y JGB had also concomitantly pulled the JPY higher towards the 111-levels from the 113-levels before the beginning of speculative activities.

- As expected, the BOJ left its key policy parameters unchanged with the policy balance rate at -0.1% and 10-year JGB yield target at around zero percent. It did make very minor tweaks to its policy though by shifting ETF allocation from the Nikkei to the Topix and to allow more flexibility in bond operations. Just as important, the BOJ introduced forward guidance for its policy rates, expecting to keep low rates "for extended period of time". The BOJ decision today signals that policy normalisation is unlikely within our forecast horizon and this should lead to the flushing out short-USDJPY positions made that the BOJ would tweak its policy parameter expectations. This should keep the USDJPY supported above the 111-levels. Consequently, the USDJPY rebounded to an intraday high of 111.46 (on 31 Jan).

- USDJPY has been tracking net portfolio flows into Japanese assets. On a three-month moving average basis, foreign inflows into Japanese assets have rebounded after slipping lower since the start of the year. JPY weakness and a buoyant US economy have lifted corporate earnings amid simmering global trade tensions, encouraging foreign inflows into Japanese equities. We however did not see a concomitant rise in the JPY with the foreign inflows into Japanese assets. Instead, the JPY weakened with net portfolio inflows. This suggests a strong positive correlation between portfolio inflows into Japanese assets and the USDJPY and this is attributable to foreign investors hedging their Japanese asset purchases against further JPY depreciation by short-selling the JPY. Thus, inflows into Japanese assets have been positive for the USDJPY, possibly accounting for the weakness in the JPY so far.

- In an environment of rising trade tensions between China and US, global risk aversion should spur an increase in demand for safe-haven assets, particularly the JPY. However, it appears that demand for JPY assets is completely offset by broad USD strength amid monetary policy divergence, healthy US economic data and optimism over US corporate earnings for now. More importantly, the measured response from China over the additional tariffs announced by the Trump administration appears to have calmed markets, de-escalating tensions between the two world's largest economies.

- This has made the USD the more sought-after currency refuge in the face of global risk-off sentiments compared to the other traditional safe-haven proxies like gold, JPY and CHF. JPY appears to be underperforming this time round due to it losing its shine as a safe-haven proxy play, exposing the currency to USD moves amid an environment of rising protectionism. This is because Japan itself is vulnerable to any fall-out from the escalation of trade tensions between China and the US. At the same time, Japan steel and aluminum and motor vehicle exports are also targets of US protectionist measures.

- Just as important, carry trades are back with the JPY as a funding currency. Investors borrow JPY to invest in USD assets in search of higher returns. All of these should lead to increase long-USD short-JPY positioning that should keep the USDJPY supported.

- This is reflected in recent CFTC data that showed market positioning for further USD strength. Market has been mostly net short-JPY, i.e., expecting weakness in the JPY since May. Investors have more than doubled their short-JPY bets from 58,754 contracts at the start of May to 123,762 contracts as of the week of 24 Jul, and have reduced their long-JPY bets to 49,993 contracts as of the week of 24 Jul vs. 57,349 contracts at the start of May. Given expectations for further USD strength in the next three months, we could see further net short-JPY positioning that should put downside pressure on the JPY.

- We however do not expect USD strength against the majors, including the JPY, to extend beyond 3Q 2018. A milder downtrend for the USD is expected towards the end of the year though we cannot rule out bouts of USD strength. We maintain our view that the USD is bound for a broad pullback because of (1) rising US deficit and debt from US tax reforms; (2) reserve diversification away from USD; (3) USD countercyclical play; and (4) broad USD downtrend cycle. Thus we expect JPY weakness to peter out towards the end of the year.

- Downside pressure on the JPY is also likely to come from importer demand for foreign currency (usually USD). Healthy economic growth and improvement in wages have seen healthy import demand (up 7.7% y/y in 1H 2018). With economic growth expected to remain healthy (BOJ expects real GDP to expand by 1.6% in FY2018), import demand should remain healthy, and increased import demand should weigh on the JPY. On the other hand, anecdotal evidence suggests exporters could park their export earnings abroad on expectations of further JPY weakness and repatriate earnings only during quarter-end for book-keeping purposes.

- At the same time, 4Q tends to be a seasonally strong month for the JPY vs. the USD, and there is the potential for the JPY to rebound in the last three months of the year. This is likely to mitigate the downside pressure on the JPY and lift the JPY higher by end-4Q.

- In addition, the current level of the JPY is fundamentally undervalued by about 3.5% and this suggests some room for the JPY to depreciate mildly towards our fair value estimate. Our BEER fair value model which takes into account differentials in REER, terms of trade, GDP per capita and interest rate; net foreign assets (as % of GDP); ratio of total trade to GDP; productivity; and government consumption, estimates USDJPY at 109.

- Against the backdrop of USD strength, we have revised higher our forecasts for the USDJPY. We expect the USDJPY to remain supported as concerns over trade disruption persist. Upside pressure should see the USDJPY end 3Q higher around 115 instead of the 109 we had previously expected. Thereafter, we expect some pullback in USD strength to allow the USDJPY to ease and end the year around 112 (108 previously). In 1H 2019, we look for the pair to hover around the 111 (from 107 previously).

- **Growth and Inflation Outlook:** Despite the slowdown in economic growth momentum in 1Q 2018, the economy is expected to rebound moderately in 2Q. 2Q Tankan survey results were mixed with sentiments slipping for large manufacturers, but improved for large non-manufacturers, rising to the strongest levels since 4Q 2015. At the same time, firms are expected to increase capital spending in the fiscal year. This result appear to gel with recently released core machine orders data (indicator of capital spending by private companies ex orders for ships, electrical power companies), which showed an expansion of 16.5% y/y in May. External demand also seems to hold up well with exports rising 7.5% y/y in 3Q vs. 2Q's 5.4%, while imports moderated slightly to 7.5% y/y vs. 8.0% in 2Q. At the same time, private consumption could pick up ahead as the weather had improved unlike in 1Q. 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. The BOJ tweaked its full-year growth forecast to 1.5% (previously 1.6%) for FY2018 and kept its FY2019 forecast unchanged at 0.8%.

- Jun CPI data showed that inflation remains a distant goal. Headline inflation rose by 0.7% y/y in Jun, unchanged from May, though it was a tad off market estimates of 0.8%. Firmer energy prices supported gains in the consumer prices in the month. Both core (Headline less fresh food) and core-core (headline less fresh food and energy) inflation inched higher to 0.8% and 0.4% y/y in Jun from 0.7% and 0.3% in May, in line with expectations. There is some hope that inflation could pick-up should crude oil prices remain on the uptick, and JPY remains weak, lifting import prices and putting upside pressure on consumer prices. Still, the slow grind in inflation suggests that any talk of normalisation remains premature and that we should expect the ultra-loose monetary policy to continue. The BOJ now expects core inflation to come in at 1.1% in 2018 in 2018 from 1.3% previously and at 1.5% and 1.6% (excluding the effects of the consumption tax hike) in FY2019 and FY2020 respectively.

- **Monetary Policy Forecast:** The much anticipated policy decision on 31 Jul proved to be anti-climactic as there was no major changes to the BOJ policy framework. Instead, the BOJ maintained its policy balance rate at -0.1% and 10-year JGB yield target at around zero percent. The central bank though did make minor tweaks to its policy for the first time since QQE with yield curve control was introduced in Sep 2016, including shifting purchases of exchange-traded funds (ETFs) towards assets linked to the Topix from the Nikkei and allowing greater flexibility in bond operations and asset purchases to ensure sustainability of the current framework. It also introduced forward guidance for policy rates, saying extremely low levels of short- and long-term interest rates will remain for an extended period of time. At the same time, the central bank will also allow the 10-year JGB yield some leeway to move up and down depending on developments in economic activity and prices. In a nod to the profitability of commercial banks, the BOJ reduced the amount to which rate applies from JPY10tn.

- At the post-MPC press conference, BOJ Governor Kuroda defended the minor changes to the policy framework as improving sustainability over the long haul. He also reiterated that the central bank would add further easing measures if required in response to critics who claimed that the tweaks were stealth tapering. While we doubt that today's decision will end speculation on BOJ exit plans, it will take the wind out of JPY-bulls' attempt to push the JPY higher.

- **Latest Fiscal and External Balance Outlook:** For the financial year ended on 31 Mar, the total tax revenue collected amounted to JPY58.8tn, up JPY3.3tn from a year ago. This reflected the strong economic activity amid a weak JPY. A breakdown showed that individual income, corporate income and consumption taxes collected were JPY18.9tn (up JPY1.3tn), JPY23tn (up JY1.7tn) and JPY17.5tn (up JPY0.3tn) respectively. Accordingly, the amounted collected was higher than the initial fiscal budget for 2017 by JPY1.1tn.

  The current account (CA) surplus widened mildly to JPY1.94tn in May from JPY1.85tn in Apr, helped by the larger surplus in the primary income of JPY2.40tn (Apr: JPY1.94tn) that more than offset the goods and services deficit of JPY0.26tn (Apr: JPY0.07tn). The financial account surplus ballooned to JPY3.32tn in May after coming in by just JPY0.43tn in Apr underpinned by portfolio investment financial derivative inflows of JPY1.95tn and JPY0.22tn respectively - a reversal of the JPY1.99tn and JPY0.21tn outflow seen in Apr. "Other investment" segment moderated to JPY0.21tn in May from JPY1.36tn in Apr. Consequently, the overall balance of payments (BoP) surplus ballooned to JPY6.64tn from JPY0.85tn in Apr.

Key domestic events and issues to watch: Focus in Aug will be on preliminary print for 2Q18 GDP on 10 Aug. In the absence of a BOJ meeting in Aug, BOJ Deputy Governor Amamiya's speech in Kyoto on 2 Aug will come under scrutiny. BOJ will release its minutes for its 14-15 Jun policy meeting on 3 Aug and summary of opinions for it 30-31 Jul policy meeting on 8 Aug. Eye will be also on CPI for Jul on 24 Aug. JGB auctions in Aug: 10-year (2 Aug), 30-year (9 Aug), 5-year (16 Aug), 1-year (16 Aug) and 20-year (21 Aug).

- **Technical Outlook:** USDJPY traded a month of 2 halves - rising in the first half of Jul to as high as 113.17 (19 Jul) before easing lower into month-end. Last seen at 111.30 levels. Bearish momentum on daily chart remains intact but shows signs of waning while stochastics shows tentative signs of turning from oversold conditions. Room for downside could be limited to 110.60 (50 DMA), 110 (200 DMA). Immediate resistance at 111.60 (50% fibo retracement of 2016 high to 2018 low, 21 DMA). Decisive close above this could re-ignite USDJPY bulls. Resistance at 113.30 (61.8% fibo), 114.50 and 115.30 (76.4% fibo).

RMB: Challenges Far From Over

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDCNY	6.75 (--)	6.72 (--)	6.65 (--)	6.62 (--)
USDCNH	6.77 (6.75)	6.72 (--)	6.65 (--)	6.62 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** USDCNH had a rather tumultuous Jul with a rally to a high of 6.8446 made on 24 Jul. While there was certainly some intervention spotted, PBoC maintains a mostly hands-off approach for most of the past several weeks and that emboldens the yuan bears. After a state council meeting, there was a series of fiscal spending announced to cushion growth in a backdrop of a brewing trade war. Sentiments were eased for a while by these growth-boosting measures though we caution that (1) trade war is far from over and the US is building allies, (2) another possible RRR cut is RMB negative. So, we anticipate that more weakness could still be possible for the RMB especially within this quarter before a possible recovery into the next quarter. We hold our forecast for USDCNY to end the year around 6.72. We tweak the USDCNH forecast for 3Q a little higher to reflect a 200pips premium between the USDCNH and USDCNY as we anticipate RMB to remain under pressure for much of this quarter before seeing some recovery at the end of it. For much of the next few weeks, expect the forward curve to remain really flat or even inverted as PBoC continues to taper the long end of the curve while allowing spot to be more market determined. The USDCNH 12M forward points have collapsed to just 230 pips while the onshore is in negative.

- **The War At Hand:**
  - The trade war was started somewhat officially when the first tranche of tariffs were imposed by the US on 6 Jul. 25% tariff was slapped on U$34bn worth of imports from China. China responded in kind that same day. We see the trade war as part of the campaign program for the US mid-term elections which takes place on 6 November. That leaves exactly 4 months for Trump to carry out most of his threats. For them to be of good value (to his campaign), Trump has to ensure that much of the trade war has to happen in the first two months (Jul-Aug). Our expectations actually tie in rather well with the deadlines that have been set so far. The decision on the proposed 10% tariff for the additional U$200bn of goods, on top of the ones slapped on the U$50bn (U$16bn of which is in the making at this point) will have to be made after 31st Aug. Public hearings supposed to be made on the plan between 20-23rd Aug. So we expect trade war concerns to remain at fore for the next 6 weeks or so.
  - The US has started to be a little more amenable to trade deals with the EU. The meeting between President Juncker and Trump had a rather positive outcome with an agreement to "work together toward zero tariff, zero non-tariff barriers, and zero subsidies on non-auto industrial goods". An Executive Working Group of their closes advisors was said to "immediately" set up to "carry out this joint agenda, identify short-term measures to facilitate commercial exchanges and assess existing tariff measures". Shortly after, there was some news of US considering waiving the additional 25% steel tariff for India if the country offers an acceptable proposal to lower the volume of its supply. More recently, ties between India and China had started to warm as China plans to lower tariffs with India and pledged to import certain goods like cheaper medicines from India that were previously sourced from the US. Our interpretation of the US-China trade war is that the bigger and thus, more showy war is still with China. Rather than having a multi-front war, Trump might have started to make friends with others to strengthen his position in the war with China. At this point, we see some room for RMB to weaken as the trade war is still likely to intensify. Into 4Q, the risk of further escalations in the trade war is likely to reduce as the government focuses on the mid-term elections and we look for the pressure on the RMB to ease as well.

- **Addressing Domestic Challenges:**
  - Industrial production slowed significantly in the past few months. The recent set of activity data was rather mixed as retail sales for Jun rebounded while IP continued to soften. With China facing headwinds on the trade front, a series of fiscal measures have been launched to cushion growth amid the uncertainty. That includes a plan to spend CNY1.35tn (U$199bn) for local government to spend on infrastructure with focus on transport, gas and telecommunications as well as plans to cut taxes, provide VAT rebates to encourage research and manufacturing in "advanced" and "modern service providers". This came soon after the State Council's assurance that China's proactive fiscal policy to be "more proactive". There were also news that the State Planners have said that large-scale unemployment is "not allowed" amid the trade friction. While these have certainly allowed some improvement in the RMB depreciation expectations, another RRR cut may still be necessary and that is negative for the RMB. We expect these growth boosting measures to feed into the economy and data to show some improvement at the turn of the quarter. At that point, RMB should also strengthen in line with the fundamentals.

- **Growth and inflation outlook**: 2Q GDP slowed to 6.7%y/y from previous 1Q. Retail sales quickened to 9.0%y/y from previous 8.5%. Industrial production slowed to just 6.0%y/y from 6.8% previously and urban FAI printed 6.0%y/y, in line with expectations. Accompanying the data release, NBS said that China will continue to boost domestic demand, may expedite some infrastructure projects in line with regulations as well as property tax legislation. The growth print was in line with consensus. The slowdown in industrial production is well under expectations and a reflection of the tightening regulations on shadow financing and deleveraging endeavors. The recent slew of fiscal measures is likely to boost industrial production and investment. Better prints are likely to show up at the turn of the quarter.

- New yuan loans surprised to the upside in June with a total of CNY1.84bn lent out though aggregate financing is still softer than expected at CNY1.18bn. Money supply M2 slowed to 8.0%y/y. Aggregate financing slowed to 9.8%y/y from previous 10.3%. The decline came from the persistent drop in entrusted loan, this time by -4.5%y/y, the sharp deceleration in trust loan to 10.1% from previous 16% and also a fall in banker's acceptance bill. This comes after a number of regulatory tightening on wealth management products this year. RRR cuts insofar have been targeted and are deemed to be supportive of traditional bank lendings as the authorities attempt to shift financing back to the traditional route. However, there were rumours of some regulatory relaxations on banks' wealth management rule. In addition to 0.5% cut to the "structural parameter" in the Macro-Prudential Assessment of balance sheets structural, expect some improvement on this aspect as well.

- CPI rose to 1.9%%y/y from 1.8% previously. Inflation remained subdued with food inflation still benign while transport & telecom picked up pace. The "residence" component rose a tad and that could underscore some demand in the real estate market that could spill into household consumption for other home-related goods. We see upside pressure should the US and China implement the tariffs on each other. PPI rose unexpectedly to 4.7%y/y from previous 4.1%, on the back of stronger commodity prices, though this bounce could dissipate as industrial production softens. Base metal prices have also come off, likely to weigh on PPI.

- **Monetary Policy Forecast:** Even with the series of fiscal measures, we still do not rule out another RRR cut. However, a broad-based one is less likely than a targeted one like the ones we have seen in Apr and Jul this year. China would still have to juggle between credit support and deleveraging which would have significant ramifications on the RMB as well. The widely speculated timing of the RRR cut would have to be in Oct and we anticipate an announcement after the release of the activity data.

- The average OMO rates weighted by outstanding of securities came off before heading higher more recently. This suggests that while there are plenty of measures to boost credit growth, liquidity injection is not overdone. Rescue efforts for the economy seem rather targeted. We think the RRR cut could come should data fail to show much improvement from the June set of numbers.

- **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%. However, as stated in the earlier part of this section, there were plenty of measures under taken recently. As a result, the budget deficit could deteriorate as China cushions growth in the face of a trade war.

- **Key domestic events and issues to watch:** NBS PMI numbers for Jul due on 31^{st} Jul, Caixin PMI on 1^{st}; FX Reserves on the 7^{th}; trade data on the 8^{th}; inflation on the 9^{h}; Money supply, new yuan loans, aggregate financing on $10\text{-}15^{th}$; surveyed jobless rate, activity data on the 14^{th}; new home prices on the 15^{th}; FX net settlement (clients) on the 17^{h}; industrial profits on the 27^{th}.

- **Technical Outlook:** This pair looks biased to the upside at this point. 6.8570 may be breached to give way towards the 6.90 figure. Momentum is weak at this point but trend is still up. We do not rule out further upmove at this point. 6.71/6.72 levels are an area of support

KRW: Stabilisation but Trade War Tensions Can Derail

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

No Change to Previous Forecasts

- **Motivation for the FX View:** We see signs of stabilisation in the KRW after the sharp sell-off (nearly 7% losses vs. USD) in Jun-Jul and possibly see room for gains towards 1,100 levels in the coming weeks as the market refocuses on the possibility of BoK rate hike at the MPC meeting on 31st Aug after BoK Governor Lee signaled rate hike in coming months (but gave no timeline). Still a cautious environment of lingering trade war tensions, US data relative outperformance, Fed policy normalisation or even market disappointment with BoK (our base case remains for Oct-Nov hike) could still keep USDKRW broadly supported on dips. To add, US public hearings on another round of tariffs on $200bn imports from China will take place on 20 - 23 Aug. We do not rule out the risk of another round of tit-for tat response from China. This could reignite weakness in the KRW. We expect to see greater volatility and a slightly wider trading range of 1100 - 1145 over the next few weeks in August.

- We **retain our view for BoK to keep policy rate on hold at 1.5% at the upcoming MPC meeting on 31st Aug** amid signs of deceleration in growth momentum, worsening labor market conditions (slowest pace of job growth in 8 years), inflation not picking up as fast as expected (still below 2% BoK's target) and ongoing trade war tension in US-China (pose downside risks to global growth). 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 (possibly as early as in Oct)** if demand-induced price pressures picks up pace.

- Our study on sensitivity of Asian currencies to movements in Renminbi (proxied by CNH) and risk sentiment (proxied by MSCI World Index) using daily change data YTD 27 Jul 2018, showed that KRW is the most sensitive amongst Asian FX to changes in CNH and equities. KRW's has a beta coefficient of 1.04x and a correlation of +0.675 to movements in CNH. This indicates that KRW is positively correlated to movements in CNH and even reacts slightly more than movement in CNH (as KRW's beta coefficient is slightly more than 1). KRW's beta and correlation coefficients vs. risk sentiment (proxied by MSCI World Index) stands at 0.374x and +0.495. What this means is that a sell-off in both equities and CNH should see KRW much worse off. That said, the reverse is also true - recovery in CNH and firmer equities should support gains in KRW. External drivers including movements in CNH and trade war development will be closely watched given the significance they have on KRW.

- **Growth and Inflation Outlook: BoK has recently revised lower (by 0.1ppts) its FY GDP forecast for 2018 and 2019** to 2.9% and 2.8%, from 3% and 2.9%, respectively). And the decision was to reflect latest economic trend - sluggish job creation, slower exports amid escalating trade war tensions between US and China.

- **South Korea's economic growth momentum moderated in 2Q (+0.7% q/q vs. +1% in 1Q), owing to slower pace of expansion in private consumption and investments** (in particular facilities and construction investments). On y/y basis, 2Q GDP was up 2.9%, from 2.8% in 1Q. Exports of goods and services rose by +0.8% q/q (vs. +4.4% in 1Q) led by increase in exports of semiconductor and petroleum & coal products. Breakdown of the exports component however saw a divergence in performance with services export rising due to rebound in Chinese tourist arrivals (after ban was lifted) while goods exports slowed. On the production side, manufacturing, utilities and services rose while construction declined.

- **Inflation held steady at +1.5% y/y in Jun (unchanged from May)** as higher prices from transport and food & beverages were offset by declines in industrial products and agricultural goods. Core CPI eased modestly to 1.2% y/y in Jun, from 1.3% in May. In a monetary policy report submitted to the National Assembly, the BoK expects CPI to pick up in 2H 2018 and reach near BoK's target inflation on 2% on recovering global economy and rising public utility rates. BoK added that a weakened KRW will contribute to pushing up import prices while rising oil prices will push up prices of oil-related products.

- **Monetary Policy Forecast**: We **retain our view for BoK to keep policy rate on hold at 1.5% at the upcoming MPC meeting on 31st Aug** amid signs of deceleration in growth momentum, worsening labor market conditions (slowest pace of job growth in 8 years), inflation not picking up as fast as expected (still below 2% BoK's target) and ongoing trade war tension in US-China (pose downside risks to global growth). **We see room for BoK to remain patient for now; monitor economic situation at home and abroad (trade war) and keep monetary policy accommodative for the time being but expect a 25bps hike in 4Q 2018 (possibly as early as in Oct)** if demand-induced price pressures picks up pace. Minimum wage could 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. We also expect the BoK to monitor if inflationary pressures from the demand side pick up and if higher oil prices over the past month translate into higher CPI prices ahead.

- At the last MPC meeting on 12 Jul, BoK kept policy rate on hold at 1.5%, as widely expected but there is 1 dissenting vote from the Board. And this could potentially raise the probability of a rate hike in coming months. Lee Il-houng, a distinguished Economist was the lone dissenter in the 7-member board, as he voted for rate increase. Back in 2017, he was also the lone dissenter at the Oct 2017 meeting which subsequently paved the way for the first rate hike in 6 years the following month in Nov 2017. Accompanying statement noted that downturn in labor market, slow pickup in inflation and US-China trade dispute added to policymakers' concerns (fear of collateral damage to other export-reliant economies including Korea). Nonetheless BoK

Governor Lee said that although the outlook for the year has been revised down to 2.9% (from 3%), the BoK still see the economy growing at its potential rate… the growth and inflation trajectories aren't all that different from paths seen in April. In addition at the recent parliamentary session (27 Jul), BoK Governor Lee said that it will be necessary to adjust the level of accommodative monetary stance in an attempt to secure more policy leeway to deal with future business cycles if the economy stays on a good cycle. We believe these comments are strong hints that the BoK is preparing markets for rate hike soon.

- **Latest Fiscal and External Balance Outlook:** Current account surplus accelerated and widened to 8-month high of $8.68bn in May (from 6-year low of $1.77bn in Apr). The rebound was due to robust global demand for Korean-made semiconductors which saw strong chips exports. Trade surplus for goods in May rose to highest level since Nov-2017. This marks the 75th consecutive month of current account surplus which started in Mar-2012.

- President Moon's expansionary fiscal policy is coming under pressure as unemployment had worsened and income inequality has widened. The monthly job growth average of 142,000 between Jan and Jun 2018 was one the slowest growth since 2008-09 Global Financial Crisis. This is despite 2 supplementary budget plans being introduced (first was KRW11tn back in 2017 and the second was KRW3.9tn extra budget in May 2018 aimed at creating 50,000 jobs for youth). Hiring rate stood at 61.4% in Jun, way below the government's long term target at 70%. To be sure, President Moon has been increasing fiscal spending on the back of a continued rise in tax revenue but such spending efforts may not have met its intended objectives. A fiscal report by the Ministry of Strategy and Finance showed that Korea's tax revenue amounted to 140.7 trillion won in the first five months of this year, up 16.9 trillion won from the same period of last year.

- **Key domestic events and issues to watch:** S. Korea releases Jul exports, CPI, PMI Mfg (1 Aug); Jun current account balance (3 Aug); Jul export/import price (14 Aug): Jul unemployment rate (17 Aug); Jul PPI (21 Aug); Business survey for Mfg and Non-Mfg (30 Aug), Jul IP, BoK MPC Meeting (31 Aug).

- **Technical Outlook:** USDKRW strength faded in Jul. This was in line with our call in the last FX Monthly where we called for retracement risks. Pair was last at 1117 levels. Bullish momentum on weekly chart shows signs of waning while stochastics shows signs of falling from overbought conditions. Mild bearish momentum on daily chart remains intact while stochastics is falling. Downside risks not ruled out in the near term. Key support at 1111.5 (38.2% fibo retracement of Jun low to Jul high) before 1105 (50 DMA). Firmer support at 1094 (61.8% fibo). Resistance at 1122 (23.6% fibo, 21 DMA), 1130 levels.

SGD: Weighed By Near Term External Headwinds

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

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** In the absence of fresh catalyst, we maintain our USDSGD outlook for the next three- to twelve-months for now. We continue to expect upside risks to lift the USDSGD higher to 1.3750 by end-3Q before easing off towards 1.3650 (previously 1.30) by end-2018 as trade tensions ease. The pair is expected to drift further lower 13600 and 1.3550 by end-1Q and -2Q 2019 respectively

- The SGD has gone from being one of the worst performers among its ASEAN peers in Jun to outperforming all of them in Jul. From a loss of 1.55% against the USD in Jun, the SGD is now showing gains of 0.06% in Jul. Healthy US data, expectations of Fed rate hikes and potential re-escalation of Sino-US trade war concerns had been supportive of the USD, lifting the SGD to a new 2018 high at 1.3746 (on 3 and 19 Jul). The recent pullback in the USD though has provided some breathing space to the SGD and allowed it to slip back towards the 1.36-levels. We do not expect SGD strength to persist but instead expect the SGD to slip possibly lower towards the 1.37-levels in Aug. We do not expect any changes to our USDSGD forecast in the next three- to twelve-months for now.

- The threat of trade disruption from tit-for-tat tariffs imposed by US and China on each other weighs on Singapore, which is acutely reliant on trade. Already there are signs that the synchronised export-led recovery is losing steam. Recently released data showed electronic manufacturing growth slowing to single-digit levels, while exports of electronics contracted by 7.9% in Jun, reflective of the fading global electronics cycle. Trade disruption from protectionist measures is likely to exacerbate this slowdown and weigh on the Singapore economy, dragging the SGD lower consequently. Should the trade disputes escalate into a trade war, there could be downside risks to our SGD outlook.

- At the same time, we do not expect any sharp reversal in USD strength as US growth remains healthy and expectations of firmer inflation is supportive of the USD in the near term. Instead, there could be broad gains in the USD against the AXJs as higher yields and still strong corporate earnings still favour US assets vs. emerging Asian assets. Firmer USD is likely to remain a drag on the SGD and keep the USDSGD elevated.

- Also possibly supportive of the USDSGD is our expectations for a firmer USDCNY in the quarter. PBoC's move to ensure two-way moves in the CNY amid unresolved trade disputes with the US could see

USDCNY firm. A firmer USDCNY should weigh on the SGD given increasing positive sensitivity of USDCNY move on the USDSGD.

- Seasonally, Aug tends to be a weak month for the SGD vs. the USD, and this could suggest SGD weakness in the month. In nine out of 10 years, the SGD has weakened against the USD in Aug. We could thus see the USDSGD climb higher from current levels. We cannot rule out the possibility of a USDSGD move towards the 1.37 levels in Aug before edging even higher by end-3Q.

- Underscoring the SGD though is its still healthy domestic fundamentals. The healthy budget surpluses of the past few years provide fiscal space for the government to accelerate its infrastructure programme, including development of Changi Airport Terminal 5 and the redevelopment and rejuvenation of the Jurong Lake District, should it become necessary. Aside from the country's ample fiscal space, its triple-A status and persistent high balance of payments surpluses are also 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.

- **Growth and Inflation Outlook:** Advanced estimates for 2Q showed growth softening to +3.8% y/y (1Q: +4.3%) underpinned by a moderation in services sector growth. Services eased to +3.4% in 2Q vs. 1Q's +4.0% - the slowest pace in a year. Manufacturing though continued to expand healthily, rising +8.6% in 2Q (vs. +9.7% in 1Q) boosted largely by biomedical manufacturing. Electronics manufacturing though slowed from its double-digit growth to single-digits. Construction remained a drag on growth, declining by -4.4% in 2Q vs. -5.2% in 1Q due to continued weakness in private sector activities. Recently released industrial production print for Jun, where it expanded by a healthy 7.4%, suggested that manufacturing activities are likely to be stronger in 2Q than estimated in the preliminary GDP print. At the same time, our economic team also expects services growth to be raised to 3.6-3.8% given the healthy Jun reading. Consequently, our economic team expects final 2Q GDP to be revised higher to +4.3%. For the whole of 2018, the team maintains its real GDP forecast at +3.5% because of concerns over escalating trade tensions. It also kept its 2019 growth forecast unchanged at +2.7%. MTI expects GDP to come in at within 2.5-3.5%.

- Both headline and core inflation picked up in Jun, rising +0.6% and +1.7% y/y respectively (May: +0.4%; +1.5%). Private road transport edged higher as well, rising +0.4% in Jun vs. +0.1% in May underpinned by higher fuel prices and a more moderate decline in car prices lifted headline inflation in Jun. In addition, accommodation costs fell at a slower pace of -3.0% in Jun vs. May's -3.2% due to softer rentals. Driving core inflation higher in the month was food and services inflation, which rose +1.5% and +1.7% y/y respectively from May's +1.3% and +1.6%. For 1H 2018, headline inflation and core inflation have averaged +0.3% and +1.5% respectively.

- Looking ahead, 2H 2018 should see some increases in administrative prices, including Changi Airport fee and water price hikes. Electricity tariffs have also been raised by +6.9% for 3Q amid higher oil prices. Consequently, our economic team maintains its headline and core inflation forecast at +0.7% 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 had climbed to a new 2018 high at 1.3746 twice (on 3 and 19 Jul) in the month amid USD strength. Pair has since eased off to hover around the 1.3618-levels at the point of writing. The firmer USDSGD and rising 10Y UST yield so far have kept the 3-month SOR supported around the 1.30-1.61 region in Jul, 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 1.6326% on 11 Jul. 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 slightly 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 1.89% and 1.77% respectively by end 3Q 2018. For end-2018, we continue to expect the rates to accelerate to 2.09% 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 201gp7. 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:** Final estimates for 2Q18 GDP will be released sometime 8-14 Aug, while CPI for Jul is schedule for release sometime 20-26 Aug.

- **Technical Outlook:** USDSGD traded 1.3528 – 1.3746 range for the month of Jul. Last seen at 1.3620 levels. Bullish momentum on weekly chart remains intact but shows signs of waning while stochastics is in overbought conditions. Daily momentum and stochastics are bearish bias. Further downside play towards 1.3540 (50 DMA) not ruled out. Resistance at 1.3750 (double top).

MYR: Getting Close to the 100th Day Deadline

Forecast	3Q 2018	4Q 2018	1Q 2018	2Q 2019
USDMYR	4.0800 (--)	4.0300 (--)	3.9800 (--)	3.9800 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** In line with most other regional currencies, the MYR weakened against the USD by around 0.6% in the month of Jul. It reached a high of 4.0725 on 27 Jul 2018, due largely to uncertainties from the escalation of trade war and its concomitant CNY weakness. The weaker exchange rate also reflects the drop in crude oil price which fell to a low of $71.84/bbl at 16 Jul 2018 from this year's high of USD79.2/bbl on 29 June 2018. It is currently at around $74/bbl, but on year to date basis crude oil price has appreciated +14.7% from USD64/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.

- The risk of a possible global trade war becoming more sustained, coupled with continuing Fed policy normalisation and repatriation of corporate earnings, 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, 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 marginally by –USD0.1b to USD104.6b as at mid July 2018 from USD104.7b at end-June 2018, amid continued net foreign sells in Malaysian equities and bonds. The latest external reserves figure is equivalent to 7.5 months of retained imports and 1.1 times of short term external debt.

- The key factor affecting external reserves in 1H July 2018 is the indication of continued - but slower pace of - portfolio capital outflows. Foreign net selling of Malaysian equities in 1H 2018 continued this month i.e. –MYR1.4b in 1-19 July 2018 (June 2018: -MYR4.9b) although the pace eased as market reacted positively to PH Government’s decision to continue with the KVLRT3 project at lower cost, pushing FBMKLCI to close above 1,700 points on 12 July 2018 and reached 1,754.67 on 19 July 2018. Meanwhile, our Fixed Income (FI) Research team takes the view that net foreign selling in the bond market in 2Q 2018 (-MYR24.3b) continues this month. However the dips in MGS yields so far this month suggest some stabilization in the local bond market on easing foreign selling pressure plus local buying e.g. 10-Year MGS yield eased to 4.098% as at 20 July 2018 from last month’s high of 4.22% on 8 June 2018. Meanwhile, maturity-related foreign selling in the bond market is expected to be manageable. Of the total of MYR35.7b of MGS+GII maturing 2H 2018, consisting of MYR20b in GII - where foreign holdings of total outstanding GII is 4.8%, and MYR15.7b in MGS - where foreign holdings of total outstanding MGS is 40.1%.

- We expect the declines in external reserves over the past few months to stabilise this quarter as net foreign outflows from the equity and bond markets this year have reversed the bulk of the earlier net foreign inflows. Year-to-date, the –MYR8.3b net foreign selling of Malaysian equities reversed 78% of the +MYR10.6b foreign net buys in 2017. Meanwhile, the –MYR24.3b net foreign net selling in the bond market in 2Q 2018 reversed 74% of the +MYR32.8b net foreign buying in the preceding 12 months (Apr 2017 – Mar 2018).

- 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. Index of leading economic indicators fell -0.7% YoY in May 2018 (Apr 2018: +1.4% YoY). Growth-wise, the index has been on a soft patch since Dec 2017. Given that the index growth leads GDP growth by 2-3 months, it signals further slowing in real GDP growth in 2Q 2018 and 3Q 2018 after the deceleration in 4Q 2017 and 1Q 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).

- BNM in its latest monetary policy statement highlighted that private consumption will be supported by continued wage and employment growth, with an additional lift from higher household spending due to the consumption tax holiday. The central bank also expects inflation this year to come in lower due to the impact of the 0% GST rate and fuel price stabilization which is positive for consumer sentiment. We expect private consumption growth to pick up to +7.3% this year (1Q 2018: +6.9% YoY; 2017: +7.0%) before moderating to +6.7% next year given the transitory impact of the consumption tax holiday.

- Inflation rate slowed sharply in June 2018 to +0.8% YoY (May 2018: +1.8% YoY) as the zero rating of GST resulted in slower increases or declines in prices of CPI basket of goods and services, except transport. MoM, inflation declined -1.2%. Revised our 2018 inflation rate forecast to 0.5%-1.0% from 1.5%-2.0% previously (1H 2018: +1.6% YoY; 2017: +3.7%) as we expect a period of disinflation and deflation.

- The sharp deceleration in headline inflation in June 2018 was attributed to slower increases or declines in prices of goods and services except for transport, reflecting the impact of "consumption tax holiday" following the zero rating of GST vs the standard rate of 6% beginning June 2018 until Aug 2018. At the same time, RON95 petrol and diesel prices are maintained at current levels of MYR2.20/litre and MYR2.18/litre respectively until end of this year as the government subsidize the fuel prices at the cost of MYR0.33/litre. However, RON95 and diesel prices were lower back in June 2017, averaging MYR2.00/litre and MYR1.92/litre respectively, and effective 7 June 2018, RON97 petrol price was re-floated on weekly basis to reflect global crude oil price movement. Consequently, transport costs bucked the trend by rising at a faster pace of +5.5% YoY May 2018: +3.8% YoY). Given the slump in June 2018 headline inflation rate and the likelihood of negative inflation rate or deflation in subsequent months, we revised downward our 2018 and 2019 headline inflation rate forecasts to 0.5%- 1.0% (from 1.5%-2.0%) and 1.5%-2.0% (from 2.0%-3.0%) respectively. Headline inflation for 1H 2018 period stayed subdued at +1.6% YoY while core inflation at +1.5% YoY during the same period.

- **Monetary Policy Forecast:** BNM kept the OPR unchanged for the third consecutive meeting this year after the recent MPC on 10-11 Jul 2018. The latest Monetary Policy Statement (MPS) was dovish on inflation with expectation of negative headline inflation rate for some months and low inflation rate in 1H 2019 on the effect of the 0% GST rate in June-Aug 2018 and the fuel price stabilization until end-2018 before the impact of these factors dissipates. Consequently, BNM expect headline inflation for 2018 to be lower than the current official forecast of 2.0%-3.0%.

- The sub-1% inflation rate in June 2018 and the likelihood of disinflation and deflation until early next year will keep inflation subdued in 2018- 2019 as per our revised forecasts above, in turn supporting our view of no change in BNM's current Overnight Policy Rate (OPR) level of 3.25% until end-2019 after the +25bps hike at the Monetary Policy Committee (MPC) meeting on 25 Jan 2018.

- Furthermore, unless the US Fed turns very aggressive on its interest rate hikes vs the current guidance, there is currently "positive carry" in terms of the differences between Malaysia and US interest rates and between domestic interest rate and inflation rate which should not necessitate further interest rate hike this year. Malaysia is also ahead of the curve 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 (3 Aug); FX reserves (7 & 21 Jul); Industrial Production (10 Aug); CPI (24 Aug), BNM Policy Meeting (11 Jul); GDP 2Q (16 Aug).

- **Technical Outlook:** USDMYR continued to inch higher for the month of Jul. Last seen at 4.06 levels. Underlying momentum remains bullish as shown on weekly chart but stochastics on weekly chart is in overbought conditions. On the daily chart, momentum turned mild bearish while stochastics is falling from overbought conditions. We do not rule out risk of pullback. Key support at 4.0505 (21 DMA). Further downside towards 4.02 not ruled out if 21 DMA is breached. Resistance at 4.07, 4.10 remains

IDR: Still Not Out Of The Woods Yet

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

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** With an eye to trade war concerns, Fed rate hike moves and twin deficits amid higher oil prices, we maintain our outlook for the IDR in the next three- to 12-months. We look for the USDIDR to end-3Q at 14450 and then for the pair to gradually trend lower towards 14250 by end-2015 underpinned by the government infrastructure spending ahead of the elections in 2019. In 1H 2019, some volatility in the markets can be expected as the Presidential election approaches and with our expectations for a Jokowi win at this juncture - supportive of the IDR - the USDIDR should edge lower to 14100 and 13900 by end-1Q and -2Q 2019 respectively.

- The IDR continues to underperform its regional peers despite policy rates having been raised by 100bp to maintain macroeconomic and financial stability. The BI's dual intervention in the FX and bond markets, amounting to over USD12bn of its foreign reserves since Feb, has failed to stem the sell-off in the IDR though it did manage to prevent the IDR from rising too rapidly. The IDR weakness so far can be attributed to the expected pace of Fed rate hike and the simmering trade tensions between the China and US amid underlying weak domestic fundamentals. We expect the IDR to remain under pressure in the one- to three- months ahead though the IDR should settle around 14450-levels by end-3Q.

- The persistent deficit in the current account continues to highlight the IDR vulnerability. The current account deficit is expected to widen in 2Q due to seasonal factors, namely the Ramadan festivities and infrastructure needs. At the same time, elevated oil prices above USD70/bbl is likely to widen the current account deficit as well given its status as a net oil-importer. In addition, the government's ambitious infrastructure programme as well as the preparation for the upcoming Asian games is also likely to have weighed on the current account deficit. On the bright side though, the BI expects this deficit to improve in 3Q and 4Q, allowing the current account deficit to come in around 2.0-2.5% in 2018, which should lessen the downside pressure on the IDR.

- We expect downside pressure on the IDR to continue for a little while long. This is because <u>Aug tends to be a seasonally weak month for the IDR vs. the USD, unlike Jul. In all of the past 10 years, the IDR has weakened against the USD in Aug. Thus, there is a potential for the IDR to head lower in the month.</u> The IDR could retrace as a result with the possibility of a USDIDR overshoot back above the 14500-levels before easing to end 3Q around the 14450 levels.

- The sell-off in equities and debt that had weighed on the IDR has dissipated. It appears that foreign investors have renewed their interest in Indonesian assets in Jul after selling them off for the previous five months. Foreign investor had purchased USD35.3mn and USD396.9mn in equities and debt in Jul so far. This has allowed the IDR to reverse some of its losses from earlier in the month. Risk to this is that sentiments can just as easily change and lead to a sell-off in Indonesian assets and weigh on the IDR, especially as trade tensions are expected to re-escalate ahead (this time the response from China). More importantly, foreign holdings of Indonesian sovereign debt are among the highest in the region, making the IDR vulnerable to any sell-off triggered by market stresses.

- Limiting the downside moves in the IDR in 2H 2018 is the relatively healthy economic growth of 5.1-5.5% expected in 2018, bolstered by the government's USD400bn infrastructure programme. 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. There are also expectations for a broad USD downtrend in the medium term that could weigh on the USD and lift the IDR higher. Together, these should allow the USDIDR to continue its slow grind lower over the next three-twelve months.

- **Growth and Inflation Outlook:** The economy is expected to accelerate in 2Q after coming in at a sluggish 5.06% in 1Q supported by fiscal policies, including 13th-month pay and holiday bonus for the Eid celebration that should have lifted consumption spending. Motorcycle and motor vehicle sales have risen in 2Q with the former up by 19.0% in and the latter by 4.8% (May: 4.0% and 3.0% respectively). Note that motorcycle sale is a proxy for consumer spending, and its rise is an indication of stronger private consumption ahead. The stronger showing in 2Q showed that consumption is likely to have picked up. Our economic team remains upbeat about growth prospects and expects government spending and external demand to support growth ahead, especially given 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 should also bolster 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 expects the economy to expand by 5.2% in 2Q and for full-year to come in 5.1-5.5% for the full-year.

- Headline inflation again decelerated, coming in at 3.12% y/y in Jun compared to 3.23% in May. Food prices and transport cost accelerated mildly in Jun to 4.67% and 1.93% (May: +4.47% and +1.70%) respectively but was partially offset by the slippage in housing & utility costs (Jun: 1.87% vs. May: 2.50%). Core inflation though continued to accelerate for the fourth straight month, rising 2.72% y/y in Jun from May's 2.65%. Further climb in consumer prices though 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 2.82% respectively for 2018 as compared to BI's target range of 2.5-4.5%.

- **Monetary Policy Forecast:** After lifting its benchmark policy rate by 100bp to 5.25% so far this year, the BI paused to allow the previous rate hikes to work their way into the economy. At the same time, the deposit and lending facility rates were also left unchanged at 4.25% and 6.00% respectively, keeping the interest rate corridor at 75bp on either side of the policy rate. This pause remains consistent with its policy of being "front-loaded, pre-emptive and ahead of the policy curve" and did not take away from the hawkish stance of the central bank. According to the governor, the focus remains on maintaining economic stability, including FX stability. While the policy decision takes into consideration rising Fed fund rate and trade war concerns, we believe that the future policy adjustment will depend on the IDR performance. Our economic team expects the pause to extend for the remainder of the year, but we cannot rule out further rate hikes this year should the IDR remain under pressure. Note that the BI will announce its policy decision on 15 Aug instead of 16 Aug due to a state event on 16 Aug.

- Meanwhile, the BI also announced plans to relaunch the Certificate Bank Indonesia (SBI) for tenors on 9M and 12M that had been withdrawn to curb speculative activities by foreign investors previously. The re-introduction of SBIs should attract both domestic and foreign investors, thereby ensuring greater liquidity in the system. The first sale of the SBIs has taken place on 23 Jul. The BI plans to hold monthly auctions for the 9- and 12-month SBIs. At the same time, the BI will launch a new overnight rate based on transactions (coined as INDONIA – Indonesia Overnight Index Average Rate) in place of the current JIBOR rate that is derived from bank quotations. The use of this new rate will begin on 1 Aug and will co-exist with the JIBOR for a transition period until the latter cease to be quoted in 2019.

- **Latest Fiscal and External Balance Outlook:** Finance Minister Sri Mulyani expects the budget deficit to come in at 2.12% of GDP in 2018, lower than the 2.19% target set for the year. Already in 1H 2018, tax revenue rose to IDR581.54tn, higher than the IDR510.2tn collected in 1H 2017. For the full-year, the government expects tax revenue to rise by 23%n to IDR1,424tn by end-2018. 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.

- After narrowing to USD5.54bn (2.15% of GDP) in 1Q 2018, the current account deficit is expected to widen in 2Q due to seasonal factors. Imports rose strongly ahead of the Ramadan festivities and infrastructure needs. With the end of the Eid holidays, imports have fallen and the trade deficit is expected to normalise. This is reflected in the rebound in the trade balance to USD1.74bn after being in deficit of USD3.08bn in Apr and May. Nevertheless, BI expects the current account deficit to narrow in 3Q and 4Q consequently as seasonal factors fade and global trade tensions ease. For 2018, the BI is projecting a current account deficit of 2.0-2.5% of GDP. According to the BI governor, there is a strong commitment by the government to control the current account deficit. Some of the measures include strengthening policy on exports, encouraging tourism and developing industries that can substitute imports. Success in this area would be positive for the IDR. Our economic team expects the current account deficit to come in around 2.2% of GDP.

- **Key domestic events and issues to watch**: 2Q18 GDP will be released on 6 Aug. We then have BI meeting to decide on monetary policy on 15 Aug, instead of 16 Aug. This is because President Jokowi will address the nation and deliver his 2019 state budget speech to Parliament on 16 Aug. Also, the presidential nomination for next year's presidential race in Apr will take place 4-10 Aug. Note that the Asian Games will take place from 18 Aug to 2 Sep in Jakarta/Palembang.

- **Technical Outlook:** USDIDR eased from recent high of 14564 (24 Jul) and was last seen at 14410 levels. Daily momentum turned bearish while stochastics is falling. Retracement risks not ruled out. Support at 14220 (50 DMA). Resistance at 14480, 14560 levels.

PHP: Another Rate Hike May Still Not Be Enough

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

No Change To Previous Forecast

- **Motivation for the FX View:** PHP has been the best performing ASEAN currency in Jul, except for the SGD. In Jul so far, the PHP has managed to gain 0.06% vs. the USD, a complete reversal of the 1.47% loss for the whole of Jun. This gain in the PHP can be attributed to the reaffirmation by the BSP for further rate adjustments to anchor inflationary expectations. At the same time, central bank intervention in the FX markets to stem PHP volatility has also helped to limit the slippages in the PHP recently. Not surprisingly, the PHP has eased off from its 2018 low of 53.639 on 19 Jul and is hovering around the 53.200-levels at the point of writing. Still, we do not expect PHP strength to continue unabated, constrained by weak underlying fundamentals. We continue to expect the PHP to slip lower against the USD from current levels in Aug and to end-3Q around 54-levels.

- Initially, the BSP had believed that the two 25bp rate hike in May and Jun was sufficient to anchor inflationary expectations as inflation was thought to peak by 1H 2018. However, this has proven not to be the case with inflation still accelerating. This led to a sell-off in the PHP against the USD and threatened to destabilise the financial markets. In an effort to calm markets, the BSP governor re-affirmed his plans for “strong follow-through monetary adjustment” at its next policy meeting, making another rate hike all but a reality. The expectations of an imminent rate hike is spurring unwinding of long-USDPHP positions, lifting the PHP higher currently.

- While PHP strength could continue, weak underlying fundamentals are likely to constrain and weigh on the PHP. The trade deficit hit a historical high of USD3.7bn in May after exports underperformed while imports remained elevated. At the same time, overseas remittances have moderated from 12.7% in Apr to 6.9% in May. In addition, the current account deficit is likely to have widened even more on elevated oil prices (in value terms) given that Philippines is an oil-importing economy. The government’s ambitious infrastructure building programme is likely to keep the current account in deficit in 2018 and possibly into 2019 as well. These suggest that the current account deficit is unlikely to see any significant improvement ahead. Importantly, the current account deficit has been on the broad downtrend since 2015. Further deterioration should weigh on the PHP.

- Meanwhile, the fiscal position continues to deteriorate. The tax reforms championed by President Duterte have yet to show any significant results in terms of revenue collection. For now, there is little sign that the tax reforms will reverse the fiscal deficit that has plague governments for the longest time anytime soon. Instead, the fiscal deficit is likely to worsen further given the ambitious 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.

- Further downside pressure on the PHP is likely in Aug. Unlike Jul, Aug tends to be a seasonally weak month for the PHP vs. the USD. In eight of the past 10 years, the PHP has typically weakened against the USD in Aug. There is thus a potential the PHP to slip lower in the month. This should offset some of the upside pressure on the PHP and be supportive of the USDPHP.

- As in Jul, foreign investors continued to divest their holdings of Philippine equities in Aug. So far, a total of USD63.5mn in equities have been sold off by foreign investors in Aug amid concerns over BSP rate hikes and trade war concerns. The sell-off in Aug adds to the sell-off so far this year with USD1.28bn in equities sold. Still, there is some bright spot. In recent days, foreign investors have returned to the equity markets as global risk appetite improved and purchased USD26.4mn in the week of 23 Jul, providing the PHP with some support. Our analysis using the Cyclical Adjusted P/E (CAPE) ratio model though suggests that 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 once the current risk aversion episode fades could keep the PHP supported and prevent the PHP from climbing beyond the 54-levels this year.

- We maintain our USDPHP unchanged for now and continue to look for the pair to climb higher towards the 54-levels by end-3Q on global risk aversion. Thereafter, the USDPHP should ease to 53.50 by year-end as trade tensions fade and USD strength softens. Political risk though 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 before easing to and 53.80 by end-2Q 2019.

- **Growth and Inflation Outlook:** The government remains optimistic that its 2018 growth target of 7-8% for 2018 will be achieved despite the two 25bp rate hikes so far this year by the BSP. Growth is likely to remain underpinned by strong investment growth, supported by government spending. The government intends to accelerate its planned PHP8tn infrastructure building programme, pushing forward infrastructure building, including bridges, subway in Manila, a new airport north of Manila and railways connecting Manila to the provinces. This should mitigate the decline in contribution from exports, which have contracted by 5.0% y/y in the first five months of the year. At the same time, still healthy overseas remittances to date should be supportive of private consumption. In the first five months of the year, remittances have risen by 4.2% y/y – on track to outpace the 4.3% gains seen for the whole of 2017. Still, amid the two rate hikes so far this year, our economic team is now looking for the economy to expand by 6.8% in 2018. For 2019, our team maintains their real GDP growth forecast at 6.8%.

- Headline inflation rate (base year = 2012) surged in Jun, accelerating by 6.1% from +5.7% y/y on sustained inflationary impact of the first phase of tax reform measures as well as elevated food (6.1% y/y), beverages (20.8% y/y), utility (4.6% y/y) and transport (7.1% y/y) costs. Core inflation (CPI excluding selected food items as well as energy prices) also accelerated to 4.3% y/y in Jun from 3.6% in May. With inflation averaging at faster 5.46% in 1H 2018 - way above the BSP's target range of 2-4% for the whole of 2018 – and for inflation to peak only in Jun-Aug period before easing towards year-end, our economics team has revised upwards its 2018 inflation forecast to +4.6% from +4.2% previously. At the same time, the team also tweaked its 2019 forecast to +3.7% (from +3.8% earlier). While the central bank sees inflation risks still to the upside on minimum wage hikes expected in Oct, possible fare hikes and elevated oil prices, it expects easing rice prices should the rice reform law be passed by Congress to mitigate some of these price pressures. It also highlighted that inflation could ease. The BSP expects inflation to average +4.5% and +3.3% in 2018 and 2019 respectively.

- **Monetary Policy Forecast:** BSP had raised its overnight reverse repo rate by 25bp to 3.5% at its policy meeting on 20 Jun – the second consecutive rate hike this year. The BSP left the interest rate corridor intact with the overnight lending rate and overnight deposit rate both raised by 25bp accordingly to 4.0% and 3.0% respectively. The interest rate corridor remained symmetrical on either side of the policy rate by 50bp.

- Initial indication from the BSP was that the two rate hikes so far was sufficient to anchor inflationary expectations and further rate hikes might not be needed. However with inflation showing no signs of peaking yet, it would appear that further action from the BSP was required. On 25 Jul, the BSP governor acknowledged as much, reaffirming his plan for "strong follow-through monetary adjustment" at the monetary policy meeting on 9 Aug.

- Earlier, the governor had said that the central bank was done cutting the reserve ratio for this year. The moves to cut the reserve ratio was seen by market as at odds with the rate hikes and fueling inflationary pressures with easier credit conditions. Consequently, the cut to the reserve ratio had been met with a sell-off in the PHP. The end to the reserve ratio cuts should reassure the market and calm volatility in the PHP somewhat.

- Given the continued acceleration in inflation and the BSP governor's recent comments, we continue to expect the BSP to hike its policy rate by another 25bp to 3.75% at its 9 Aug meeting.

- **Latest Fiscal and External Balance Outlook:** The government expects to collect PHP3.208tn in revenue in 2019 to support its spending plan of PHP3.757tn. Of the PHP3.208tn collected, PHP2.331tn will come from the tax bureau, while PP662.17thn will be from the customs bureau. The government expects the first tax reform package to yield PHP181.43bn in 2019 but this is subject to

Congress approving further measures including tax amnesty, bank secrecy reforms and adjustment to motor vehicle users' charge.

- The balance of payments (BoP) deficit again more than-doubled in Jun, ballooning to USD1.18bn from USD583mn in May. For 2Q, the BoP deficit widened to USD2.03bn from 1Q's USD1.23bn. This brought the overall BoP deficit to USD3.26bn in 1H 2018, surpassing the BSP's full-year forecast of USD1.5bn. According to the BSP, the large deficit in 1H was due to the widening trade deficit (first five months trade deficit was at USD3.7bn) underpinned by imports of raw material and capital goods to support domestic economic expansion. The current account data has yet to be released but the BSP continues to expect a deficit of USD3.1bn (-0.9% of GDP) for 2018. The central bank has also revised up its BoP deficit for the whole of 2018 accordingly to USD1.5bn (-0.4% of GDP). This forecast though may yet be revised higher given the overall BoP deficit so far in 1H 2018.

- **Key domestic events and issues to watch:** Eyed in Aug will 2Q18 GDP and BSP monetary policy meeting, both scheduled on 9 Aug.**Technical Outlook:** USDPHP eased off multi-year highs of 53.63 levels to trade 53.16 levels into month-end. Bullish momentum on weekly chart is waning while stochastics is showing tentative signs of falling from overbought conditions. On the daily chart, bearish momentum and stochastics remain intact. Downside pressure may persist. Support at 52.70 (23.6% fibo retracement of 2018 low to high, 100DMA). Resistance at 52.63 (recent top).

THB: Downside Risks Persist

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

No Change To Previous Forecast

- **Motivation for the FX View:** THB weakness seen in Jun and then intensified in Jul has eased off amid a pullback in the USD. The THB has weakened to a new 2018 low of 33.526 on 20 Jul – a level not seen since Oct 2017 – as USD strength persisted. Since then though, the weakness in the THB has eased and provided the THB some breathing space. We however do not expect this mild THB recovery to continue for the rest of the quarter as we expect net foreign portfolio outflows to persist and for a rebound in USD strength in the rest of the quarter. We maintain our USDTHB forecast for the next three- to 12-months.

- The THB has regained some of its mojo in the latter part of Jul on easing global trade tensions that lifted sentiments amid a pullback in USD strength, which has spurred the return of foreign investors into Thailand. Foreigners invested USD0.15bn and USD0.25bn in equities and debt in 23-26 Jul. These inflows into Thai assets had allowed the

THB to recover from its 2018 high to around 33.359 at the point of writing. Nevertheless, we expect the sell-off to continue and weigh on the THB. Already, foreign investors have sold USD276.2bn and USD124.7bn of equities and debt so far in the month. This brings the sell-off in equities and debt to USD0.38bn and USD0.12bn in 3Q so far vs. the USD3.80bn and USD0.34bn in equities and debt sold off in 2Q.

- We believe that profit-taking activities in the equity markets since 2017 after strong foreign inflows of USD2.24bn for the whole of 2016 will persist. This because the profit-taking reflects investor belief that the economy is facing domestic structural headwinds that includes hollowing out of industries, ageing demographics and rising leverage. We do not think that these structural issues can be resolved overnight and will thus continue to weigh on Thai equities. In addition, market concerns over escalating trade war between China and US given its relatively export-dependent economy, also weigh on Thai assets. At the same time, 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.

- In addition, yield differentials between 2Y UST and Thai bond is likely to continue to widen. Market expects the Fed to lift its rates further underpinned by strong US data, while the BoT is not expected to normalise its policy rate any time soon to support the economy. These expectations should keep short-end UST yields supported, while holding Thai bond yields steady. This in turn should widen the gap between the 2Y UST and Thai bond, spurring a reallocation of assets to higher yielding US assets and buoying the USDTHB in 3Q. A 25bp rate hike is expected sometime in 4Q to begin the monetary policy normalisation process but we doubt that this move would be sufficient to keep the THB hovering below the 33.500 levels by year-end.

- Still, we do not expect a more aggressive move in the THB from here on. This is because 3Q tends to be a seasonally strong month for the THB vs. the USD. In six of the past 10 years, the THB has typically been stronger against the USD in Aug and Sep. While there is the potential for the THB to strengthen in the next two months, we do not think that this will be sufficient to completely mitigate downside pressure to the THB from risk aversion. At the same time, should trade tensions between China and US escalate further, this could disrupt trade and weigh on exports and hence growth, which should put further downside pressure on the THB. Weekly chart suggests that there could be an overshoot in the USDTHB should the 33.560 levels is taken out, but we expect the pair to eventually ease and trade back towards the 33.500-levels by end-3Q.

- At the same time, healthy macro-economic fundamentals should continue to underpin the THB and keep it from falling towards the 34-handle. 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.

- 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.

- We maintain our next three- to twelve-month forecast for USDTHB. We expect the pair to end-3Q 2018 at 33.50 and then climb higher towards 33.80 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 accelerating by 4.8% y/y in 1Q 2018, the economic growth momentum is expected to continue. Growth should remain supported by government spending, especially ahead of the general elections expected early next year. This together with planned infrastructure building projects including transport networks and the Eastern Economic Corridor should continue to bolster growth. Healthy economic prints in May/Jun suggest that growth momentum remained intact going into 2Q. Private consumption and private investment expanded by 5.5% and 3.9% y/y in the Apr-May period, up from +3.4% and +1.84% in 1Q. External demand also appears to hold up well with exports and imports rising 13.1% and 12.7y/y in May. We continue to expect 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 and the BoT, the Finance Ministry has lifted its 2018 outlook to 4.5% from 4.2% previously. In comparison, the NESDB and BoT are looking for growth of 4.2-4.7% and 4.4% in 2018. Our economic team maintains its 2018 growth forecast at 4.5%.

- Headline inflation decelerated in Jun, coming in at 1.38% y/y vs. May's 1.49%. Weighing on consumer prices was the decline in fresh food prices, which fell 0.03% y/y in Jun (vs. May's +0.74%) that mitigated partially the rise in transport & communication cost (Jun: +4.14% y/y vs. May: +3.31%) due to higher energy cost. Core inflation (headline inflation excl. raw food and energy) inched higher by 0.83% y/y in Jun from 0.80% in May, coming in at the highest level since Nov 2015. Given the climb in inflation in 2Q of +1.32% (1Q: +0.63%), the Commerce Ministry has lifted its 2018 headline inflation forecast to 0.8-1.6% with the mid-point at 1.2%, up from 0.7-1.7% previously. This comes in the heel of the BoT's upwardly revised inflation forecast 1.1% for 2018, well at the bottom of its 1-4% inflation target range for 2018. Our economic team maintains its 2018 inflation at 1.3%.

- **Monetary Policy Forecast:** The BoT has left its policy rate unchanged at 1.50% since Jun 2015. The last time the policy rate was even lower was during the Great Financial Crisis in 2009 at 1.25%. Despite the policy being on hold for so long, there does not seem to be any sense of urgency in the BoT to normalise policy. This is in contrast to its ASEAN peers who have already began the process of policy normalisation. According to Governor Veerathai Santiprabhob, the BoT can pursue an independent monetary path because of its high foreign reserves, low foreign debt and high current account balances. The accommodative policy also helps to support the ongoing economic recovery. We share the Governor's view and do not think that there is a need for the central bank to normalise rate currently given benign inflationary pressures. However as growth returns to potential, a pick-up in inflationary pressures is 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 cabinet has approved a THB63bn spending budget to aid the agriculture sector, in particular to prevent the oversupply of rice. Of this amount, more than half or THB35.1bn has been allocated for loans to farmer. To keep rice supply out of the market, the government is also encouraging farmers to stockpile their rice with loans and government co-payment of storage fees of THB1500/ton. Meanwhile, the government had also announced that it was hold the VAT tax steady at current level of 7% for another year, stating 1 Oct. Keeping the VAT unchanged would help to support domestic demand.

- The current account surplus continued to narrow, coming in at USD0.96bn in May from USD1.36bn in Apr. This is the third straight month that the current account has moderated. The softness in the current account surplus was due to the sharp drop in the primary and secondary income balances (of –USD1.74bn in May vs. Apr's +USD1.13bn) that partially offset the gains in the trade balance of USD2.69bn (Apr: +USD0.23bn). Accordingly, the overall balance of payments narrowed markedly to USD0.05bn in May from USD0.89bn in Apr. While details are unavailable at the moment, we believe that the strong investment outflows were the main culprit for the deteriorating surplus in the overall BoP in the month.

- **Key domestic events and issues to watch:** BoT meets on 8 Aug to decide on monetary policy. This comes ahead of the release of 2Q18 GDP on 20 Aug.

- **Technical Outlook:** Gains in USDTHB slowed in Jul. Pair was last seen at 33.25 levels. Bearish momentum on daily chart remains intact while stochastics has fallen from overbought conditions. On the weekly chart, bullish momentum is showing signs of waning while stochastics is showing signs of turning lower from overbought conditions. Pullback risks on the horizon. Support at 32.80 (50 DMA). Resistance at 33.60 (50% fibo retracement of 2017 high to 2018 low).

INR: Eyes Brent, USD, Rain and to some extent, RMB

Forecast	3Q 2018	4Q 2018	1Q 2019	2Q 2019
USDINR	70.00 (--)	69.00 (--)	68.50 (--)	68.20 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** USDINR had been in a rather tight range recently and the recovery in the brent crude oil continues to buoy the pair. Last seen around 68.75, our forecast for 3Q at the 70-figure is still very much a possibility if RMB continues to weaken, if global sentiments take a hit due to trade war or if crude continues to make a strong recovery. Already, RBI is said to cap the topsides for this pair. Forex reserves fell from U$399.4bn to U$387.7bn. The RBI rate hike that has been widely expected on 1st Aug is unlikely to change the trajectory. We would prefer to call for a 50bps rate hike but the activity momentum does not seem to be able to withstand further tightening. We expect this hike to be a dovish one and RBI would continue to defend the rupee using its FX reserves for the rest of the year.

- Looking within, the monsoon season is going into its third month and according to the latest fortnightly report by the India Meteorological Department, the monsoon deficit has narrowed to just -2% (actual vs. normal rainfall). That could support agricultural output and temper food costs, positive for the rupee. However, domestic factors are not the only ones that drive the currency. Eyes remain on the external headwinds and risks remain to the upside at this point, towards and even beyond the 70-figure in the near-term.

- **Growth and Inflation Outlook:** Activity numbers suggest some slowing in its growth momentum. Industrial production decelerated to 3.2%y/y from previous 4.8%. The slowdown was broad-based with infrastructure goods slowing from 7.0%y/y to 4.9%. Consumer durables decelerated from 4.5%y/y to 4.3%. The only subcomponent that rose was primary goods. Base on the Industrial Output Survey made by the RBI every quarter, there seems to be some signs of softening in the second quarter as indicated by the order books in the RBI forecast.

- External demand remained positive with exports up 17.6%y/y vs. the previous 20.2%. Imports growth quickened to 21.3%y/y vs. the previous 14.9%. Trade deficit widened though to U$16.6bn. While investment activity could be slowing, the rise in imports growth, whilst negative for current account, could also be a sign of strong private consumption. However, that could still be impinged by rising price pressure and thus, justifies the market's expectations (including ours) for a rate hike tomorrow.
- CPI quickened to 5.0%y/y in Jun from previous 4.87%y/y. Food costs softened a tad but the housing, fuel and light component accelerated, propping up the headline. With brent crude still rather supported and rupee still under pressure, this feeds into a vicious cycle of inflation that could eventually crimp on demand. WPI is also racing higher to 5.77%y/y vs. the previous 4.43% and well above the expected 5.23%. According to the Nikkei PMI-mfg for Jul, purchasing managers have said that the input cost inflation is at the sharpest since July and Markit reported that firms raised their output charges at the fastest pace since Feb. That was a report that described solid demand conditions but it also noted that the business sentiment was at the weakest level seen since last Oct.
- **Monetary Policy Forecast:** RBI is poised to raise repo rates by another 25bps to 6.50% tomorrow and the reverse repo to 6.25%. Our view for a rate hike will be in line with consensus, unlike the move in Jun (where we saw a risk of rate hike, which was out of consensus). The hike this time is going to a rather dovish one just like what we witnessed in Jun as the central bank hope for this to stem the weakness in the rupee as well as the rise in inflation. We would like to call for this hike to be a 50bps hike to end all hikes but current growth conditions do not allow it. Industrial production seems rather subdued at 3.2%y/y in May vs. the previous 4.8%. Hence, a 25bps move tomorrow could still be the last and with the move already widely expected, INR may not see much support from there.
- Stabilizing the rupee is essential to tempering price pressure and supporting domestic demand. Hence, RBI has already spent some amount of its forex reserves to defend the currency. Daily intervention may not be enough. With a rate hike already widely expected, failing to do so could probably weaken the rupee as the RBI could be perceived to defer a rate hike and risk falling behind the curve.
- With brent crude prices above the U$70/bbl-level, rupee remains under pressure. Apart from the crude swings, RBI has to count on the direction of the USD, a good monsoon that could temper food costs and more importantly, further correction in the brent crude prices lower for rupee to see further strength. Risks at this point are still to the upside for now. Growth momentum may not be strong enough to withstand further rate increases and thus, RBI may have to sit on their hands after 1st Aug and cross their fingers.

- **Latest Fiscal and External Balance Outlook:** Forex reserves fell for the past two months as of May, a sign that RBI defends the rupee. With brent crude still rather lofty, current account is still at risk of further deterioration. 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. The RBI also released a report on the states budget, reporting that the consolidated gross fiscal deficit overshot the budget estimates in 2017-18 due to shortfalls in own tax revenues and higher revenue expenditure. For the coming year, the government estimates fiscal deficit to improve to 3.3%.
- **Key domestic events and issues to watch:** PMI-mfg on 1st Aug and RBI rate decision as well; IP on the 10th; trade data on 12-15th; CPI on 13th; WPI on 14th. Jul fiscal deficit and 2Q GDP on the 31st.
- **Technical outlook:** 1M NDF remains rather biased to the upside in line with most USDAsians. Last seen around 68.95. Momentum is lacking for this pair. Needs a breakout of the 68.40-69.50 range to know its next direction. A break of the 2015 high of 69.43 could see a potential test of 71.30. Support is seen around 68.00.

VND: Weakening Bias For Now

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

No Change to Previous Forecasts

- **Motivation for the FX View:** USDVND was last seen around 23258 as we write on the 30th Jul. Just as we are optimistic that the RMB could turn the corner towards the end of the quarter, so are we for the dong. Risks in the near-term could still be to the upside for the USDVND as portfolio flows are only in mild positive for Jul thus far. Fortunately, Vietnam still attracts foreign direct investment and the FDI rose 2.2%y/y for Jul. FDI growth just got back into positive terrain for the first time this year in year-on-year terms. More recently, PM Nguyen Xuan Phuc hosted a reception in Ha Noi for investors interested in investing in a U$4bn LNG power project in the Mekong Delta province of Bac Lieu. Keen interests for direct investments could still buffer the VND against further equity outflows should the trade war escalate. In a trade war, there is little benefit in keeping the VND too strong as well and SBV may want to retain a little export competitiveness in this challenging and uncertain environment.

- Foreigners sold a net U$105.9mn of equity in Jul so far (as of 30 Jul). For a country that is so reliant on trade and exposed to China and the US, the ongoing trade war between the US and China definitely casts a shadow on the VND. That explains the outflow seen in the equity markets. We look for the USDVND to remain a tad biased to the upside 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 towards the end of the year.

- **Growth and Inflation Outlook:** Markit reported another strong print for the manufacturing sector at 55.7vs. the previous 53.9. That was the data read for Jun and industrial production came in to be 14.3%y/y for Jul, quickening from the previous 12.3%. The month saw rather strong output from the manufacturing sector which offsets the softening in the electricity and gas sector as well as the subdued expansion in the mining and quarrying subcomponent. Retail sales in accelerated in Jul, lifting the retail sales for the first 7 months to 11.1%y/y from previous 10.7%.

- CPI actually edged lower to 4.46%y/y from previous 4.67%. Food costs came off along with health care. This was in line with the drop in fee for healthcare services that took effect on 15 Jul. This was instructed by the newly issued circular according to the Deputy Minister of Health Pham Le Tuan. The drop also likely support household consumption.

- According to the last available data, 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.

- 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:** We hold our view that policy rates are unlikely to change for the rest of the year. 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. Fortunately, Jul CPI softened to 4.46%y/y from previous 4.67%. 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	115	112	111	111
EUR/USD	1.1700	1.2000	1.2200	1.2300
GBP/USD	1.3200	1.3700	1.3400	1.3700
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	4.08	4.03	3.98	3.98
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	95.21	92.77	91.77	91.06
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	3.55	3.60	3.59	3.59
MYR/HKD	1.92	1.95	1.96	1.96
MYR/CNY	1.65	1.67	1.67	1.66
GBP/MYR	5.39	5.52	5.33	5.45
AUD/MYR	3.02	3.02	3.10	3.18
NZD/MYR	2.73	2.82	2.83	2.87
MYR/IDR	3542	3536	3543	3492
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 31 Jul 2018

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

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