Maybank

Macro | FX Research

Global

FX Monthly

2016, Issue VIII: Will Asia Weather Sep FOMC?

Key themes[1]

- First, US Fed timeline for eventual future rate hike still remains data dependent but has heightened following recent hawkish official comments by Fed officials recently. US growth recovery remains on track even as enhanced volatile market activity post-Brexit remains likely. *Still expect USD to be mildly positive with some strength in Sep if the hike begins then.* We are now expecting a hike in 4Q 2016 *(likelihood in Dec with some likelihood of a Sep hike)*.
- Second, the dateline for achieving Japan's 2% inflation target remains at 2H FY 2017 (by Mar 2018) due to oil softness and the lack of traction in wage increases. The credibility of Abenomics has waned somewhat in 2016 even though the easing bias is still clear. *We expect further QE in Sep which will likely weigh on the JPY.*
- Third, post-Brexit, EU contagion risks remain and could weigh on the EUR but this appears to be a medium term issue for now.
- Fourth, China still has excess capacity, heavily indebted corporations and huge liquidity injections continue to add immense pressure on the economy and the yuan medium term. PBOC continues to rely on SLF, MLF and PSL as liquidity tools rather than interest rate cuts and RRR cuts. The 6.70-level is seen as the line to be defended by PBoC for now, ahead of key events like the G20-Summit in Sep and the official SDR inclusion on 1 Oct. *Expect USDCNH and USDCNY to come under upside pressure as markets price in a Sep rate hike. CNH to strengthen against basket (non-USD) at the same time, against EUR, AUD, JPY. Watch NFP first.*
- In the lead up to Sep/Dec FoMC, USD could be more supported against G7 majors (i.e. GBP and EUR) than against AXJs. High yield plays may emerge, lending support to AXJs including AUD, IDR, INR, PHP. In current low rate environment, mildly supported risk sentiment and somewhat stable commodity prices, carry trades could outperform - Bias to Long AUD, MYR, IDR. We take opportunity to add hedges to our view by buying USD on dips. Given EU contagion risks, we continue to favor selling EUR and GBP on rallies. *Nonetheless, we could also see higher volatility from currently low volatility environment, which may lead to outflows from some currencies which have seen significant inflows and are exposed to trade swings such as KRW, TWD and SGD.*
- Oil supply & demand likely to improve, so prices should be moving higher in 2H16. The oil market is in a "shoulder season", where all the refiners have already finished stocking for the summer driving season, and the next seasonal pick up will be 4Q for winter demand. Despite, new equilibrium post Brexit and the recovery in US rig counts, diminishing supply of oil surplus remains due to the lag of capex in the past 18 months. For next 6 months we are supportive oil and metal prices benefitting MYR, CAD and AUD.
- *Oil supply & demand likely to improve, so prices should be moving higher in 2H16. The oil market is in a "shoulder season", where all the refiners have already finished stocking for the summer driving season, and the next seasonal pick up will be 4Q for winter demand. Despite, new equilibrium post Brexit and the recovery in US rig counts, diminishing supply of oil surplus remains due to the lag of capex in the past 18 months. For next 6 months we are supportive oil and metal prices benefitting MYR, CAD and AUD.*

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

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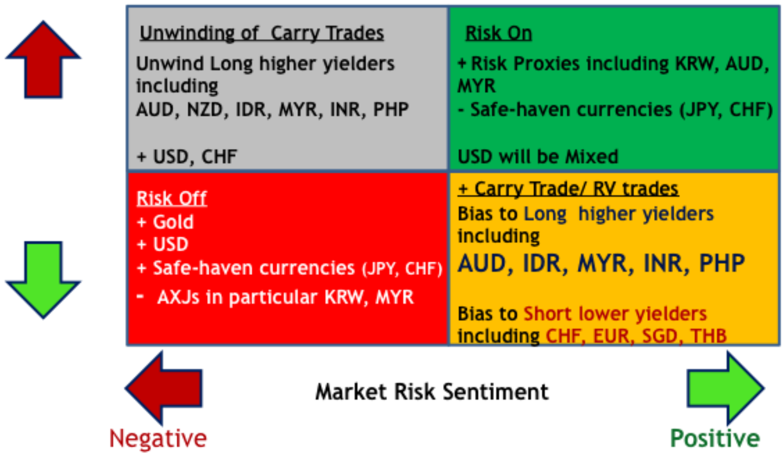
So what?



- **Macro Themes:** We stick to our view that Fed is likely to raise target rate in Dec 2016. Even so, risk of at least one 25bps move earlier in 4Q 2016 (Sep) which we mentioned last month, has materialized post-Jackson Hole. We anticipate occasional potential shifts towards the top left quadrant from the bottom right (yellow quadrant) in the 2by2 grid shown above as we proceed ahead to Sep FOMC.
- The FX GamePlan Grid above assumes all major central banks except US remain on accommodative monetary policy (low rates for longer); global growth outlook remains subdued/below-trend growth and that markets remain driven by US Fed rate hike expectation and risk sentiment. We think that assumption and environment remains and has not changed for the past few months.
- **Major Currencies:** Expect USD to see modest strength but not by the magnitude we have seen last year. Risk aversion and re-pricing of Fed hike expectation could support the USD. GBP to see bearish bias, weighed by political/Brexit uncertainty, risk of BoP crisis and BoE easing. EUR is trying find its equilibrium level now (although it is still far away from our fair value of 1.20) but is likely to be weighed down by medium to long term concerns of EU contagion risks (arising out of Brexit), European banking sector stress (Italian banking sector and Deutsche Bank) and ongoing risk of ECB easing. Higher yielding and good quality sovereign bonds benefit in low global rates environment, given AAA rating. Near-bottom commodity prices, stronger iron ore prices and weaker domestic financial sector profits which reduce the risk of an easing, also protect the downside for AUD. NZD continues to be weighed by expectation for RBNZ monetary easing and macro-prudential policies but recent upswing in dairy prices and tourism sector growth has delayed the move in the near term. Yield differentials in favor of Kiwi could mitigate some of the negativity. We still expect further easing moves by the BOJ in Sep to complement fiscal stimulus should weigh on the JPY, though safe-haven flows could limit weakness in the JPY. Overall, monetary policy in G7 excluding the US, have been ineffective and reliance on fiscal policy to boost the environment is likely to be a protracted process.
- **AXJs:** We continue to expect some weakness in the MYR in the short term but expected to see gains amid fund inflow, supported oil prices and positive risk appetite into Asia for now. Domestic and external headwinds continue to weigh on the SGD. Government spending and quasi-safe haven inflows though should be supportive. Risks of further MAS easing cannot be ruled out but is not our base case. SGD should remain weak. The improving economic fundamentals and introduction

of reforms and economic liberalization (including the tax amnesty law) should continue to generate positive sentiments and encourage greater FDI and portfolio inflows into Indonesia. These should be IDR-positive. The Philippines economy should outperform its regional peers but implementation/execution risk under the new administration could weigh on the PHP for the next 3-6 month. Risks from regional geopolitical tensions arising from the South China Sea claims could undermine the Philippines economy. We remain bearish on the PHP. High yield, strong growth, recent policy reforms underpin the INR. We are wary of GST implementation uncertainties.

- We still see potential inflows into AXJs as markets search for higher yielding plays amid a near-zero rate environment (in the developed world). In the medium term, we favor IDR and INR.
- Risks to our view are faster and larger than expected US Fed rate hikes, sharp deterioration in China's growth, crude supply overhang that could drag on oil price and a Donald Trump Win. Any Fed signaling that is seen as overly hawkish and significant spike in global FX volatility could unravel some of the inflows we have already seen into Asia.

G7 Global Overview

USD: Dollar

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD Index	98.52 --	98.91 --	99.84 --	99.04 --

No Change from Previous Forecast

- **Motivation for the FX View:** We expect at least one rate hike in 4Q 2016, more likely in Dec after the US Presidential elections. We do caution that additional repricing of a surprise Fed hike earlier in Sep (due to market complacency over Fed rate hike trajectory) could continue to see UST yields higher in particular Treasuries 2y and below, and see **USD strength (buy the rumor) in the lead-up to the FOMC** meetings. At the same time, post Brexit search for FX equilibrium and surprise Fed hikes may lead to lower risk sentiment and rising risk premiums, before it affects global consumption, investment growth and then the real economy. During this transition phase and around FOMC announcements, we believe the **USD could still be mildly supported**.
- Recent economic data including home sales, retail sales, consumer sentiment, durable goods orders have remained generally firm but recent data have been mixed particularly. Labor market is at or near full employment and inflation progressing towards Fed's medium term objective of 2% but recent Jul FOMC statement indicates that pace of improvement in the labor market has strengthened and that economic activity has been expanding at a moderate rate. Job gains have strengthened in June following weak growth in May. Growth in household spending has strengthened. Overall the July FOMC statement provided a more positive outlook on the US economy and labor market but relatively unchanged view about the benign inflation outlook. What stood out was the reduced cautious stance about external risks to the US outlook, as it added a new statement that "Near-term risks to the economic outlook have diminished".
- Recent developments post Brexit, have led to increased risk aversion and concerns about impact on global growth. We do observe there have been ongoing adjustments with regards to Fed rate hike expectations - Implied probability of Fed hike in Sep, Nov and Dec have risen from lows only a month earlier.
- The tone of the FOMC Minutes released in Aug was not much different from the Jul statement. There was a general agreement that "labor market conditions remain solid and slack had continued to diminish" and "most anticipated that inflation would rise to 2 percent over the medium term". However, the key takeaway from the Minutes is that there was a general agreement that "it would be prudent to accumulate more data" before tightening. All in all, there seems to be no indication that the Fed is on the cusp of raising rates. There was no strong indication that suggests the Fed is about to raise rates. Minutes showed a divided committee - FOMC members agreed that it "was prudent to accumulate more data in order to gauge the underlying momentum in the labor market and economic activity.

- More recently, at the Jackson Hole symposium, Fed Chair Yellen's speech did not contain any strong hint of imminent rate hike, but it was the Vice-Chair Fischer's comments that came shortly after Yellen that sent UST yields higher and USD firmer against most currencies. Yellen said "case for increasing interest rate has strengthened in recent months" while Fischer reinforced it via his interview with CNBC (shortly after Yellen's speech) when asked "if investors should be on the edge of their seats for a rate hike as soon as September and for more than one rate hike this year", in which he replied "I think what [Yellen] said today was consistent with answering yes to both your questions, but these are not things we know until we see the data." USD fell post-Yellen's speech but went bid after Fischer's interview. Key data to watch this week - US payrolls. A better than expected number should see USD higher but prior to that, we think USD index could trade 95-95 range in the lead-up.
- However, we think any moves on the dollar is conditional on upcoming FOMC statements, Fed speaks and projections. We expect the Fed to acknowledge that recent economic data remains relatively resilient, continues to reiterate gradual and cautious pace of tightening; economic/inflation projection have been revised lower from previous quarter's projection; but dots plot still signal at least one rate hike this year.
- **Growth and Inflation Outlook:** The second reading on GDP figures announced on 26 Aug, showed that 2Q GDP was revised lower to 1.1% from 1.2%. The latest revision shows some concern about the need to see consumer spending continue to drive expansion.
- Household spending grew at a 4.4% pace, revised from an initial estimate of 4.2% (forecast was 4.2%) and added 2.94% points to GDP growth. Biggest downward revisions compared with initial estimate were in state and local government spending, inventories, net exports.
- In the June FOMC, Fed's forecasts for US GDP growth and inflation rate for 2016 were trimmed to 2.0% annual rate (from 2.2% annual rate) and 1.4% YoY from 1.2% YoY respectively, although the unemployment rate forecast remain at 4.7%. Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2% over the medium term as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. The next FOMC projections will be released on 22 Sep.
- **US July CPI flat in July.** The CPI headline was flat in July, consistent with consensus expectations, as energy prices posed a significant drag. This followed a 0.2% increase in June. Core CPI, which excludes food and fuel, rose 0.1% (forecast was 0.2%). CPI was depressed by cheaper gas, hotel rates, airfares, groceries and used cars. But medical-care costs increased by most since Feb. YoY CPI were up 0.8% in July; whilst core CPI was up 2.2%. Price pressures were absent with the exception being higher rents and medical-care costs. Overall, consumer inflation was slightly cooler than expected in Jul. The major cross-currents that have been supporting the CPI over the past several quarters remained intact at the start of the second half, including low energy prices, import-price deflation in the goods sector, high shelter/rental costs and emerging price pressures elsewhere in the service segment. Real hourly earnings rose 0.4 percent, the most since January.
- Fed's preferred measure of inflation - PCE core inflation for July remains at around 1.6% y/y in Jul. While most survey measures of longer-run inflation expectations show little change, on balance, in recent months, financial market measures of inflation compensation have declined.

- **Monetary Policy Forecast:** Fed kept the target fed funds rate (FFR) at 0.25%-0.50% for the fifth consecutive FOMC meeting this year after the 25bps hike at the 15-16 Dec 2015's FOMC meeting. We are pricing in a 25bps hike at this year's final FOMC meeting on 13-14 Dec 2016 i.e. after US Presidential Election.
- The key changes in the latest FOMC statement is on the assessment of labour market condition and pace of economic activity i.e. the former "strengthened" (vs "slowing pace of improvement" previously) while the latter "expanding moderately"(vs "picked" up previously) as household spending "growing strongly" ("strengthened" previously), with the addition of "near term risk to the economic outlook have diminished" and the removal of "drag from net exports".
- Despite the more positive assessment on the labour market and economic growth conditions, we believe the Fed is "event-driven" than "data -dependent" at this juncture. This was exemplified by the no rate change decision at the 14-15 June FOMC meeting that came just before UK's EU referendum on 23 June 2016, and there is the upcoming US Presidential Election (8 Nov 2016) that is preceded by the FOMC meetings on 19-20 Sep 2016 and on 30 Oct –1 Nov 2016.
- Quick analysis of Fed's interest rate moves during the previous 10 US Presidential Election years suggests Fed is independent of the election cycle. However, Fed may have to factor in the political economy risk from the upcoming US Presidential Election, especially in view of the Republican's candidate Donald Trump's campaign rhetoric of getting tough on immigration and trade, to the extent of building walls at US-Mexican border, renegotiating existing free trade agreements (FTAs), and slapping heavy duties on imports from China and Mexico.
- The pause in FFR hike at FOMC meetings so far this year after the 25bps hike at the 15-16 Dec 2015's FOMC meeting underscores Fed's "data-dependent" and "event-driven" decision-making process.
- Our view is Fed will do a replay of 2015 i.e. another year of 25bps hike at the final FOMC meeting of this year on 13-14 Dec 2016 i.e. after US Presidential Election, especially if Democrat's Hilary Clinton wins. To note, within the context of Fed's dual mandate of maximum employment and stable prices, one of Clinton's expected key policies is the hike in Federal minimum wage.
- Under the outgoing President Obama, the proposal was for a hike to USD10.10 per hour (partially enacted for individuals working on new federal service contracts in 2014) from USD7.50 per hour (which was last increased in 2009 from USD6.55 per hour). If happened, the minimum wage hike could sustain the upward trend in wage growth since late- 2015 amid falling unemployment rate which can lifts inflation rate towards Fed's preferred 2% level.
- Interestingly, Donald Trump is now expressing support for minimum wage hike, although his view for this to be done at the discretion of the individual states instead of being mandated at Federal level.
- **Latest Fiscal and External Balance Outlook:** Fiscal sustainability risk continues to weigh on the outlook and may emerge after the Nov 2016 presidential election. In the long term, an improved US economy and manufacturing sector, US shale oil and gas production may improve the US current account leading to dollar support but this is likely to be long drawn and may probably begin only in 2017/2018.
- **Key domestic events and issues to watch in Aug 2016:** Key US events: ISM Manufacturing Mar (1 Sep) (expected: 52.0); Factory Orders (2 Sep); NFP (2 Sep); FOMC release (22 Sep); CPI (16 Sep); GDP

2Q (29 Sep); PCE Core (30 Sep). Fed Mester speaks in Kentucky (2 Sep); Fed Lacker speaks in Richmond (3 Sep); Fed Williams (7 Sep); Fed Rosengren (9 Sep); Fed Kashkari (13 Sep).

- **Technical Outlook:** DXY turned higher, since mid-Aug and had continued to head higher. Last seen at 95.70 levels. Daily momentum and stochastics are indicating a mild bullish bias. Look for a near-term rebound to continue. First level of resistance at 95.80 levels (50% fibo retracement of 2016 high to low) before 96.30 (200 DMA). A break above these levels on weekly close basis should see sustained price action higher towards 96.80 (61.8% fibo). Key support at 95.00 (38.2% fibo) before 93.78 (23.6% fibo).

EUR: Front-End Yield Differentials Take the Front Seat

Forecast	3Q 2016	4Q2016	1Q 2017	2Q 2017
EUR/USD	1.1100 --	1.1000 --	1.0800 --	1.1000 --

No Change from Previous Forecasts.

- **Motivation for the FX View:** We expect EUR/USD to be driven by front end yield differentials over the next few weeks in the run-up to ECB meeting (8 Sep) and FoMC meeting (21 Sep). EUR FX vols is expected to pick up (from current levels of 8.2%) and EUR could trade in a choppy manner but likely to be stuck within 1.0950 – 1.1360 range. While the risk of Fed rate hike in Sep has risen, we caution that a no move (our house view for Fed rate hike is in Dec 2016) may see UST yields levelling off and 2Y EU-US yield differentials narrowing. This should see EUR-shorts unwind and trade higher. We hold to our view that EUR is likely to trade in range between 1.0950 – 1.1360. We keep our EUR forecast unchanged over the forecast horizon.
- Markets re-pricing of expectation for Fed rate hike in Sep (especially after Fed Chair Yellen and Vice-Chair Fischer) saw front end UST yields higher, resulting in the widening of 2Y EU-US yield differentials to near widest levels of -145bps, and this is weighing on the EUR. Further widening of yield differential is not impossible, especially if US payrolls (2 Sep) comes in better than expected, and result in higher 2Y UST yields. But we question how much higher can 2Y UST yields go or how wide can 2Y yield differentials stretch in the meantime, absence further easing from ECB while Fed may not be able to sound as hawkish as it would like to (as inflation objective is not met and business investment has been falling). The latter will see UST yields level off. As such we think there is a limit to EUR downside. Instead the risk could be to the upside on disappointment of US payrolls and/or Fed shying away from a rate hike again.
- We had cautioned that there are many political events coming up including the Austrian Presidential elections (2 Oct), Italy referendum on constitutional reform (Late Oct/ Early Nov), Netherlands elections in Mar 2017, France elections in Apr 2017 and Germany is also scheduled to hold elections in Aug-Oct 2017, could add to uncertainty

and weigh on recovery as risk of Far-Right parties stoking anti-EU sentiment is rising. These political events and the risk of “Leave EU” referendums (if held) could undermine the future of the Euro-club, create noises, heighten the level of market uncertainty, and weigh on the EUR. But we see these as medium term risks for now.

- **Risk to our EUR Range Outlook:** While we expect EUR to be confined to 1.0950 – 1.1360 range over the next few weeks, there are a few risks that could see EUR break out of the range. (1) EUR could break lower (below 1.0950) if Fed proceeds with raising rates in Sep and continue to sound hawkish (leading to markets pricing in another hike at the end of the year) and/or ECB eased monetary policy; (2) On EUR breaking above 1.1360, if US data disappoints to the downside, leading to Fed keeping rate on hold in Sep, accompanied by a dovish Fed statement leading to sharp narrowing of EU-UST yield spreads towards -120bps from current -145bps).
- **Growth and Inflation Outlook:** 2Q Euro area growth grew +0.3% q/q (vs. +0.6% in 1Q). There is no breakdown as this is only the preliminary release. The next print on 6 Sep will contain the breakdown. On y/y terms, 2Q GDP grew 1.6% (unchanged vs. previous print). Jun IP fell by 0.6% m/m (vs. -1.2% in May). Increase was due to capital, durable consumer goods.

- Euro-area flash PMIs remain in expansionary territories, services PMI and composite PMI inched higher to 53.1 and 53.3 from previous prints of 52.9 and 53.2, respectively. Only Mfg PMI was a touch softer at 51.8 (vs. 52 prior).

- IMF has lowered 2017 growth outlook for the Euro-area to 1.4% (from 1.6%), taking into consideration the negative impact of the UK referendum outcome. 2016 growth was still projected to firm (1.6% vs. previous projection of 1.5%) due to continuation of growth momentum. ECB staff revision of forecast will only be made available in Sep 2016. We believe the UK fallout should continue to cast a shadow on Euro-area’s medium term recovery (beyond 2016).

    - From a trade perspective, UK represents 37% of EU’s total trade and a number of European countries ran trade surpluses (i.e. exports more than imports) with the UK. Disruption to trade flow will have impact on growth prospects for the EU region.
    - From a political standpoint, there are numerous political events coming up including the Austrian Presidential elections (2 Oct), Italy referendum on constitutional reform (Late Oct/ Early Nov), Netherlands elections in Mar 2017, France elections in Apr 2017 and Germany is also scheduled to hold elections in Aug-Oct 2017, could add to uncertainty and weigh on recovery as risk of Far-Right parties stoking anti-EU sentiment is rising. Not forgetting the timing of UK triggering Article 50. All these are medium term negative on Euro-area.

- **Euro-area inflation** firmed slightly to +0.2% y/y in Jun (from +0.1% in Jun). Core inflation held steady at +0.9% in Jul. ECB currently forecasts 2016 inflation to average 0.2% before picking up to 1.3% in 2017.

- **Monetary Policy Forecast:** We expect ECB to keep monetary policy status quo at the upcoming meeting on 8 Sep. New ECB staff macroeconomic forecast will also be available at this meeting. Previous meeting in Jul suggested that Draghi was less dovish than expected and data over the past few weeks did not show any break in growth momentum. We believe ECB will continue to monitor financial conditions as a result of the UK fallout and not rush into adding more stimulus, unless necessary.

- At the last ECB meeting (21 Jul), **ECB/Draghi comments were less dovish than expected.** ECB kept monetary policy status quo; noted that initial assessment of *Brexit* impact of about 0.2-0.5ppts of GDP over 3 years; reiterated its willingness, readiness and ability to act if need be.

- **Latest Fiscal and External Balance Outlook:** The government deficit ratio is projected to decline to 1.5% in 2017, from 2.1% of GDP in 2015. Projected government debt ratio is projected to decline gradually to 88.4% in 2017, from 91.5% of GDP in 2015.
- Euro area current account surplus narrowed to EUR28.2bn in Jun (vs. EUR30.8bn in May), on seasonally adjusted basis. This is the lowest level since Feb 2016 and was due to decline in surplus in services, primary income. On the other hand, visible trade surplus rose. Current account surplus stood at 3.2% to GDP.

- **Key domestic events and issues to watch:** Euro-area 2Q final GDP (6 Sep); ECB meeting (8 Sep); Sep ZEW survey (13 Sep); Aug CPI (15 Sep); Sep flash PMIs (23 Sep).

- **Technical Outlook:** EUR traded higher for the month of Aug, in line with our call for a bullish reversal. Pair rose to a high of 1.1366 (18 Aug) before easing off towards 1.1190 levels, as we write post-Jackson Hole where Yellen and Fischer combined to bring back Fed rate hike expectation, resulting in EUR/USD lower. While bullish momentum on monthly and weekly charts remains intact, daily technical suggests some short term downside risks. Support seen at 1.1120 (200 DMA), 1.1070 (50% fibo of Dec low to 2016 high), 1.0940 (61.8% fibo). Break below these support puts 1.0780 (76.4% fibo) in focus. Resistance at 1.1360 (23.6%, Aug highs) before 1.1620 levels (2016 high).

GBP: Bearish Bias Remains but Wary of Short Squeeze

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
GBP/USD	1.2500 --	1.3000 --	1.3000 --	1.3500 --

No Change from Previous Forecasrs.

- **Motivation for the FX View**: Our **bearish outlook on GBP remains unchanged**. With BoE easing out of the way, we **do not expect BoE to move again at their next MPC meeting** (15 Sep). **Political noises could return and drive the GBP, and to some extent monetary policy divergence could weigh on GBP.** But we **remain very cautious of GBP positioning at record short levels** as position **unwinding can be sharp should economic data continue to surprise to the upside.** We watch resistance at 1.3380 (previous high in Aug). Break above that could see further short squeeze towards 1.36 levels. On the downside, key support at 1.28 (interim base, double-bottom). We see risks of further downside towards 1.25.

- Recent data including retail sales, labor report, PPI, CBI orders and government finances have all surprised to the upside resulting in the GBP moving higher over the past 2 weeks. This is in sharp contrast to the worse-than-expected PMI surveys and sentiment indicators post-*Brexit* and it seems that the gloom and doom scenario widely played up by mass-media may have been blown out of proportion.

- That said we are not abandoning our bearish outlook on the GBP. We think the **full blown effects of the UK fallout remains unclear at this stage** as **much uncertainty remains over the timing of trigger of Article-50, and the exit plans/strategies** the current UK government has in place. And these have bigger medium term repercussion on UK's outlook and prospects (in terms of trade relationships, London's status as financial hub, fund flows and sustainability of job creation).
- While the past few weeks have been especially quiet on the political front due to the summer recess of the House of Commons and the abse**nce of political noise on news headlines resulted in lesser downside pressure on the GBP** (this is evident from GBP 1m vols which slumped to near Jan-Feb lows while GBP enjoyed a move higher towards 1.3279).

- Going forward **FX volatility is expected to pick up as the House of Commons returns from their summer break on 5 Sep**, and we **expect more political noise to dominate news headlines** (resulting in higher volatility), and this **could weigh on the GBP**. We also expect monetary policy divergence (between BoE on easing bias and Fed near the cusp of another rate hike) to add to some downside pressure on the GBP over the next few weeks as we head into FOMC meeting (21 Sep) as markets re-priced some expectation of rate hike in Sep (jumped from 20% before Jackson Hole to 42% chance of Fed rate hike), and we expect this mild adjustment to lend modest strength to the USD in the meantime (though it is not our base case for Fed to hike at the Sep meeting).

- **Growth and Inflation Outlook:** Prelim 2Q GDP was in line with estimates/expectations of 0.6% q/q and 2.2% y/y. Private consumption and investment rose while government spending unexpectedly fell. While PMI surveys and confidence indicators in Jul (post-*Brexit)* fell sharply (somewhat causing an initial scare), recent data such as Jul retail sales (+5.4% y/y vs. 3.9% prior/Expectation), Jun labor report (+172 in employment change vs. +150k expected), Jul PPI (+0.3% y/y vs. 0) and Aug CBI orders (-5 vs. -10 Expected, with the survey of 505 firms of order books surging to 2-year high) all surprised to the upside. Even 2Q GDP was in line with expectation. These suggest that the **initial gloom and doom could be overplayed for now and this should take some pressure off the fear of deeper recession and back to back monetary easing**. That said, it **does not mean we are no longer bearish**. We still are and we believe more clarity on the outlook should come near end-2016 or when Article 50 is triggered.

- Earlier in Jul, the IMF has cut UK growth outlook for 2016 and 2017 by -0.2 ppts and -0.9 ppts, to 1.7% and 1.3% respectively. IMF noted that the referendum will damage short-term growth prospects via lower confidence and investment but factored in favorable trade terms into its forecasts. Increase in uncertainty is projected to weaken domestic demand significantly.

- **On inflation outlook**, we expect the large decline in GBP exchange rate to exert upside pressure on prices (via the import price channel), given UK imports more than it exports. This should erode the purchasing power of the UK consumer and weigh on growth slowdown.
- Headline CPI rose marginally to 0.6% in Jul (vs. 0.5% in Jun) as a result of the jump in fuel prices. Core inflation held steady at 1.3% y/y (vs. 1.4% in Jun).

- **Monetary Policy Forecast:** We expect BoE to key monetary policy status quo at its next meeting on 15 Sep, so as to allow monetary easing (conducted at Aug meeting) to work its way into the economy. Economic conditions are not entirely at a stage which requires immediate and aggressive easing, as suggested by recent data, and BoE may want to conserve its monetary policy toolbox for use at a later stage if need arises (i.e. when more data becomes available or after Article 50 is triggered). In addition, aggressive/pre-mature move to ease rates could trigger inflation to spike. Already, a much weaker GBP is expected to result in upward price pressures (UK imports more than exports), and BoE may want to avoid a scenario where UK faces a potential stagflation in 2017 – where prices are rising and economic growth could slip into recession (arising out of the uncertainty surrounding UK exit).

- At the last MPC meeting (4 Aug), BoE unleashed a broad-based package of easing measures (more than we and consensus expected): (1) policy rate was cut by 25bps to 0.25% (this is the first cut in 7 years); (2) GILT purchases of GBP60bn over 6months; (3) Corporate bond purchases of GBP10bn over 1.5 years; (4) Term Funding Scheme (TFS) of GBP100bn for 4Y at close to bank rate (to help with transmission mechanism). We only expected rate cut of 25bps. BoE Carney explained that such easing measures were taken as the economic outlook has changed markedly and he added that elements of the stimulus can be taken further. BoE Carney however does not believe in negative rates and the lower bound of the policy rate is still a positive number.

- **Latest Fiscal and External Balance Outlook:** UK public finances were in surplus by around GBP1bn, from deficit of GBP7.8bn in Jun. Public sector borrowing has fallen to lowest levelof GBP23.7bn (FY YTD, down GBP3bn from the same period last year) since 2008, contrary to expectation that UK is in for a tough time on *Brexit*. That said we note that Jul is a period where UK receive the bulk of its corporate tax receipts. We continue to monitor the fiscal situation – if *Brexit* may not be as bad as feared.

- UK's 1Q 2016 current account deficit was last at 6.9% of GDP. This could potentially narrow due to the drop in GBP resulting in higher demand for UK exports, outweighing the higher prices of imports.

- **Key domestic events and issues to watch:** Aug PMI (1 Sep); Jul IP (7 Sep); Aug CPI, PPI (13 Sep); Jul jobs report (14 Sep); Aug retail sales (15 Sep); BoE meeting (15 Sep) – likely to be non-event; labor party election results (24 Sep) and 2Q final GDP (30 Sep).

- **Technical Outlook:** August has been a month of 2 halves for GBP, falling to a low of 1.2866 (15 Aug) before rebounding as high as 1.3279 (26 Aug). Pair was last seen at 1.3090 levels. Bullish momentum on daily chart is waning while stochastics is showing signs of falling from near-overbought conditions. Support remains at 1.28 levels (previous low and interim double bottom). Key resistance at 1.3322 (23.6% fibo retracement of Jun high to Jul low). A break above could see move towards 1.3640 (38.2% fibo).

AUD: Still Sensitive To Fed

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
AUD/USD	0.74	0.76	0.75	0.76
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No Change To Previous Forecasts

- **Motivation for the FX View:** Our projections suggest that we are looking for a rather resilient AUD. There are a few underpinnings. One, iron ore prices could be looking at a medium term bottoming as the world steel association projects slightly higher demand prices amid a well-supplied global market in 2017. While that is unlikely to give a material boost to the iron ore prices and AUD, the major part of the decline in iron ore prices is likely to already be in the price of AUD. Two, we are still in a world of fragile growth and low inflation which suggests that yield hunting will still dominate notwithstanding episodes of carry trade unwinding in times of Fed hike expectations (like now) or risk-off. In that respect, AUD is still likely to be in favour given its room for further rate cut that should boost the allure of its government bonds both in terms of yields and price gains. Third, its AAA-rating, albeit at risk, give comfort to those who seek that rare commodity.
- We have been bullish about the AUD and we remain so in the currency, even against the USD, in the medium term. In particular, Japanese investors have been favouring Australian bonds in the past two year and we expect their interest to hold. Recent news from Japan Post suggest that it will invest half of its JGB redemption in foreign bonds overseas. We have estimated the amount of overseas investment to be around USD20bn. Our forecast for Sep is maintained at 0.74 given that we see potential for the current retracement to continue into Sep. Trajectory of the AUDUSD is highly dependent on the base currency (USD) and when the Fed will time the hike. Our house view is still in Dec although we do not rule out all possibility of a rate hike in Sep. A hawkish hold is what we are looking for in Sep and that should temper the AUDUSD upsides for the rest of the next quarter. Against other currencies, expect AUD to retain its strength.
- Beyond 3Q, we anticipate focus to shift towards the US Presidential Elections. A tight race between Donald Trump and Hillary Clinton may weigh on sentiments as a Trump Win is seen as negative for Asia. We also see some risk for a Nov rate cut by the RBA which would be more effectively timed to cheapen the AUD (compared to the Aug one) ahead of a Fed hike in Dec but this time RBA faces a high hurdle of maintaining the banks' profitability as previous cuts have translated to narrower net interest margin for the banks. The AUDUSD is still sensitive to the Fed rate trajectory. Once a hike is out of the way, expect AUDUSD to head higher towards 0.76, or even beyond by year end.

- **Growth and Inflation Outlook:** Data paints a picture of cautious optimism. Jul labor report surprised to the upside but the hires were part-time. Full time employment fell -45.4K in Jul. Jobless rate slipped back to 5.7% from previous 5.8% as participation rate of labor held steady at 64.9%. Part-time employment growth has been largely positive and breakdowns of the Labour Force survey, most of the hires are in the retail and accommodation sector – tourism-related industry. Full-time hires in those industries have actually dropped, underscoring a more cautious hiring sentiment. On the side, the most resilient industry on the employment front is perhaps the construction industry that has recorded additions in full-time and part-time. The ANZ job advertisement shows a fall of -0.8%m/m for Jul.
- Capacity utilization rates of construction and services have been holding as indicated by the 6 month moving averages for both data. Putting the capacity utilization rate and the job report together, firms are still cautiously optimistic of construction and services industry. Perhaps the most optimistic, according to the Labor Force Survey, would be healthcare and education sectors.
- 2Q Inflation had rebounded by +0.4%q/q from -0.2%, buoyed by higher costs in food, transport and housing. Year-on year, inflation slowed to 1.0% from previous 1.3%. The trimmed mean version surprised with a firmer than expected print of 0.5%q/q vs. previous 0.2%. With demand still deficient and AUD rather elevated, inflation outlook is likely to remain benign.
- **Monetary Policy Forecast:** We see risk of a rate cut by RBA in Nov but it would be a very close call (again). In anticipation of a Fed move in Dec, a Nov cut would be timely to bring down the AUD. However, the hurdle to lower rates further seems rather high at this point. First, banks' profitability has been affected by the rate cut as their NIMs have been squeezed by stiff competition for deposits that has kept their cost of deposits elevated. Second, property prices have been elevated in Sydney and Melbourne and RBA would not want to risk spurring property prices.
- **Latest Fiscal and External Balance Outlook:** During the elections, Coaliton announced plans to improve welfare payment that would supposedly save more than $2bn and lift the budget bottom line by over $1bn from the budget released in May.
- To recall, the budget deficit presented in May for 2016 is expected to be A$37bn. The deficit is projected to exist for the next four years. The government expects to raise tax on tobacco and commit a record A$50bn in infrastructure investment between 2013-14 and 2019-20 for roads, rail, airports and dams. Fiscal deficit is estimated to be around -2.2% of GDP for 2016-2017 before gradually narrowing towards -0.1% by 2019-20. Real GDP is estimated to be 2.5% this year before accelerating to 3% for the next 3 subsequent fiscal years. One of the key plans is the Ten Year Enterprise Tax Plan meant to boost new investment, create and support jobs ad increase real wages. The Plan will see lower tax rates for small businesses first before progressively extending cuts to all companies by 2026-27. For personal tax, the government will also lift the tax threshold on the middle tax bracket to prevent average full time wage earners from moving into the second top tax bracket. This could serve to boost consumption in the long run.
- Current account deficit narrowed slightly to -A$20.8bn in 1Q from previous -A$22.6bn in 4Q (last available data). The improvement was

due to narrower dedicit in the goods and services with services posting narrowest deficit since 4Q 2014.

- **Key domestic events and issues to watch:** 2Q CAPEX is due on 1 Sep, along with Jul retail sales. RBA decides on cash target rate on the 6th along with the release of its current account balance for 2Q. GDP is due on the 7th. Trade on 8th. NAB business surveys are due on 13th. Labour report is due on the 15th. Minutes of the Aug meeting is due on the 20th.
- **Technical Outlook:** Weekly and daily charts show bearish bias but monthly chart indicates that bulls still have some way to go. As such we expect further retreats to be shallow. 200-DMA is seen around 0.7380. Momentum indicators are bearish and we expect the 0.7380-support to hold. 200-MMA at 0.7830 coincides with the 23.6% Fibonacci retracement of the 2011-2016 sell off and this has proven to be a strong barrier. However, price actions in the past few months have shown that bias is still to the upside. A break there should open the way towards 0.85.

NZD: Looking for the Pullback

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

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We expect NZD to trade in range of 0.6950 – 0.7450 (vs. the USD) over the next few weeks, with some initial bias to the downside due to narrowing of yield differentials between NZ and US (in favor of the latter). Markets are re-pricing their expectation to pencil in some expectation of Fed rate hike in Sep (from 20% before Jackson Hole to 42% probability) and UST yields are rising as a result. While this could weigh on the Kiwi, there are other factors such as the recent improvement in dairy prices that could mitigate the downside. On upcoming RBNZ meeting, we expect RBNZ to remain on hold, given the cut last month and recent comments that RBNZ is in no hurry to cut rate. There are no significant domestic data out of NZ in Sep (apart from 2Q GDP on 15 Sep), so focus is centered on external developments out of US FOMC (21 Sep) and commodity prices.
- NZD's rally over the past month can be attributed to a few factors including back-to-back rebound in dairy prices, Fonterra's first upward revision of milk price forecast by 50cts in almost a year, as well as RBNZ's comments of late which seem to suggest that RBNZ is not in a hurry to cut rates aggressively for fear of exacerbating imbalances for the economy.
- Taking into account recent development, we revised our 3Q forecast higher towards 0.70, from 0.6850.
- **Growth and Inflation Outlook:** In the RBNZ MPS (11 Aug), RBNZ noted that GDP growth is about average, supported by low interest rates,

high population growth, increasing residential investment and strong tourist spending. Spare capacity is being absorbed with output gap increasing to about zero, driven by tightening capacity pressure in the construction sector.

- But low export commodity prices (due to weak global conditions) continue to drag on growth. That said we do note that recent dairy prices have been on a rebound (month of August saw 2 back to back increases in GDT price index with the most recent auction on 16 Aug seeing a 12.7% jump in price). ANZ commodity price index has also show some signs of improvement rising by about 5% since beginning of the year, led by prices of meat, pelts and wool. We continue to watch for continued momentum, as rising export prices from low levels will support business confidence and business investments.

- 2Q GDP is expected to be released on 15 Sep. 1Q GDP came in stronger than expected at +0.7% q/q but was slightly weaker on sequential terms as compared to previous quarter (+0.9%). On y/y terms, GDP expanded +2.8% (vs. 2.3% in 4Q 2015). Growth was underpinned by construction, tourism and healthcare services but partially offset by primary industries (including oil/gas extraction, coal mining) as well as manufacturing.

- Subdued global environment continues to dampen inflationary pressures in NZ. This is especially so as spare capacity contributed to the decline in commodity prices and strong NZD exchange rate translated into lower import prices, suppressing tradables inflation (negative since 2012), and weigh on headline inflation (now at 16-year low and below RBNZ's 1-3% target range). The outlook for low inflation is expected to persist for longer. RBNZ cautioned there remains a risk of further declines in expectations stemming from persistent low inflation.

- 2Q headline CPI rose 0.4% q/q (vs. +0.2% in 1Q) and 0.4% y/y (unchanged vs. 1Q). The latest set of inflation data was below market expectations.

- **Monetary Policy Forecast:** Given the recent 25bps cut in Aug, we **expect RBNZ to remain on hold at 2% for the upcoming meeting (22 Sep).** Recent speech by RBNZ Wheeler (23 Aug) indicates that the **RBNZ is not in any hurry to cut rates** – "*Rapid ongoing decreases in interest rates would likely result in an unsustainable surge in growth, capacity bottlenecks, and further inflame an already seriously overheating property market. It would use up much of the Bank's capacity to respond to the likely boom/bust situation that would follow, and place the Reserve Bank in a situation similar to many other central banks of having limited room to respond to future economic or financial shocks.*"

- But looking out we think RBNZ could potentially lower OCR again later on 10 Nov, depending on data flow, in particular inflation and commodity price data. We noted that RBNZ McDermott said (12 Aug) that **RBNZ prefers to move rates in conjunction with quarterly MPC statement for effective communication.** The **next RBNZ MPC meeting with an MPC statement is on 10 Nov**. This suggests **a potential pause in monetary easing between now and Nov** for RBNZ. RBNZ also added that the LVR (macro-prudential measure to curb housing imbalance) has been postponed to 1 Oct (from 1 Sep) based on banks' feedback that more time is required to enable them to meet new restrictions that apply to investor loans nationwide, given the pipeline of pre-approvals made prior to the announcement

- At the MPC meeting (11 Aug), RBNZ lowered the OCR by 25bps, as expected. RBNZ continued to blame the 'goldilocks economy' (weak global conditions, low interest rates) for the upward pressure on NZD. It reiterated that the TWI is significantly higher (6%) than assumed in the Jun statement. It went on to blame the strong NZD for its failure to meet its 1 – 3% inflation objective. And it also mentioned that a "decline in the exchange rate is needed; further policy easing will be required"
- **Latest Fiscal and External Balance Outlook:** 1Q current account swung into surplus of NZ$1.3bn from deficit of –NZD2.61bn (in 4Q). 1Q 2016 current account deficit narrowed to 3.0% of GDP (an improvement from -3.1%). This was due to an increase in the services surplus (helped by tourism) and a decrease in the primary income deficit
- Fitch affirms NZ at 'AA' rating with a stable outlook (10 Aug), citing factors such as NZ's strong macroeconomic policy framework and prudent fiscal management, reinforced by governance standards and a business environment rated among the best globally by the World Bank. However Fitch also noted that NZ's external finances are a clear weakness relative to rated peers, with one of the highest net external debt ratios in the world and persistent current-account deficits. Fitch expects the current-account deficit to remain near 2015 levels of 3.0% of GDP for the subsequent two years, as a gradual recovery in dairy output is balanced by capital imports from strengthening domestic demand.
- NZ government posted a larger-than-expected operating surplus of $2.3bn in the first 11 months of the financial year. This was above the $1.98bn forecasted in the Budget update and suggests that the forecast full-year surplus is likely to be achieved.
- **Key domestic events and issues to watch:** 2Q Terms of Trade (1 Sep); 2Q GDP (15 Sep); RBNZ meeting (22 Sep). GDT auction on 7 and 21 Sep.
- **Technical Outlook:** NZD continues to trade higher within the upward sloping trend channel formed since Aug 2015. Pair traded 2016 high of 0.7380 before turning lower on Fed Yellen/Fischer's comments. Last seen at 0.7240 levels. Monthly, weekly technical continue to suggest that the uptrend remain intact. But daily momentum and stochastics suggests a pullback could be coming. A move towards 0.72 (21 DMA), 0.7170 levels (61.8% fibo retracement of Apr 2015 high to 2015 low) or even 0.6990 (50% fibo) should not be ruled out. Resistance remains at 0.7340 levels, 0.7390 (76.4% fibo).

JPY: Expectations of Further BOJ Easing Still Intact

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDJPY	110 --	112 --	112 --	114 --

No Change To Forecasts

- **Motivation for the FX View:** The failure of the BOJ and the government to exceed market expectations in their respective policy measures sent the USDJPY reeling towards the 100-levels. Since then, expectations that the BOJ could add to its easing measures following its comprehensive review of its monetary policy at its 20-21 Sep meeting, have risen. This together with the re-pricing of a Fed rate hike this year, which has sent the dollar higher, has lifted the pair back towards the 102-levels. Still, the USDJPY has risen by just 0.25% so far in Aug, unlike in the previous month where it had risen by over 1%.
- Reflecting the deflated confidence in Abenomics, the market continued to position for further strengthening of the JPY ahead. As of 23 Aug, CFTC data showed long-JPY bets increased to 60,316 contracts from 56,006 contracts the week before. Such bets had put downside pressure on the USDJPY. However, we suspect that some of these bets could have been unwound at the end of Aug in reaction to both Kuroda and Yellen's comments at Jackson Hole, propping the USDJPY higher. BOJ Kuroda had commented of ample space for additional easing in the BOJ's toolkit of asset buying, monetary-base expansion and negative interest rates at Jackson Hole, while Fed Chair Yellen's speech is interpreted as being consistent with a Sep hike.
- Kuroda's comments has heightened expectations that the BOJ could embark on further easing measures after the conclusion of "a comprehensive assessment of the developments in economic activity and prices under "QQE" and "QQE with a Negative Interest Rate" as well as these policy effects" at the upcoming monetary policy meeting on 20-21 Sep.
- The possibility that the BOJ could expand its easing measures in Sep to complement the massive fiscal program that PM Abe is expected to unleash should provide the USDJPY with a leg up. At the same time, the re-pricing of a Fed rate hike this year is causing the dollar to rebound. Together these should lift the USDJPY towards 110 and 112 by end-3Q and -4Q 2016 and then towards 114 by end-2Q 2017.
- We still do not expect an overly aggressive USDJPY move higher towards the 120 levels as the fiscal and monetary measures are unlikely to be accompanied by any significant restructuring of the economy - the third arrow of Abenomics - to ensure the economy's medium- to longer-term growth prospects. A breakdown in investor confidence in Abenomics could see the USDJPY headed towards the 96-levels.
- **Growth and Inflation Outlook:** Even with the BOJ's ultra-easy monetary policy and the government's first extra budget, the economy continued to underperform. The economy expanded by just 0.2% q/q annualized in 2Q, a slowdown from 2% (revised higher from

1.9%) in 1Q. This reflected the drag from exports (-5.9% q/q annualized) and a drop in business investment (-1.5% q/q annualized). High frequency data is also not supportive of economic growth ahead. Industrial production and core machinery orders remained weak, contracting by 1.7% and 5.6% y/y respectively in 1H 2016. Exports and imports remained in the doldrums, contracting by 9.5% and 18.3% y/y respectively in the first seven months of the year. The JPY4.52tn spending in the extra budget for FY2016 expected to come into effect by Oct should go some way in boosting the economy towards the end of the year and into 2017.

- Inflation again failed to gain traction despite the massive easing measures by the BOJ. Instead, headline inflation slipped by 0.5% y/y in Jul, the same pace as in Jun. Similarly, core inflation slipped slightly further to 0.5% y/y in Jul from -0.4% in Jun. Even the BOJ's favoured gauge of inflation - the core-core inflation (CPI less fresh food and energy) – moderated to 0.5% in Jul after hovering around the 0.7% levels in May and Jun. The lack of inflationary pressures continues to put pressure on the BOJ to either have an open-ended deadline to achieving the 2% inflation target or to act decisively with another round of comprehensive easing measures to reflate the economy and achieve the 2% inflation target by Mar 2018.
- **Monetary Policy Forecast:** After reacting adversely initially, market appears to be more comfortable with the news that the BOJ will be conducting "a comprehensive assessment of the developments in economic activity and prices under "QQE" and "QQE with a Negative Interest Rate" as well as these policy effects" at the next monetary policy meeting on 20-21 Sep. This was especially after the BOJ governor Kuroda reiterated at Jackson Hole that there was ample space for additional easing in the BOJ's toolkit of asset buying, monetary-base expansion and negative interest rates. This message reassured market that the prospects for further easing measures remain intact at its 20-21 Sep meeting.
- We still expect the BOJ to expand its easing measures further in Sep. These measures could include expanding the monetary base to JPY100tn from JPY80tn currently, increasing the purchase of ETFs to JPY10tn from JPY6tn and cutting interest rate further to -0.3%. Helicopter money – i.e. the BOJ directly underwriting the government's debt or manages monetary and fiscal policy as one – is unlikely at this point in time given the governor's disdain. Moreover use of this option would require not only the support of PM Abe and FinMin Aso, but also legislative changes to allow the BOJ to engage in 'helicopter money'. We believe that this 'nuclear option' could be used as a last resort should other measures fail to reflate the economy.
- **Latest Fiscal and External Balance Outlook:** The cabinet has approved the draft second extra budget for fiscal 2016 on 25 Aug. The JPY4.52tn extra budget for FY2016 brings the total public outlay for through Mar to over JPY100tn. The government intends to issue JPY2.75tn of construction bonds to fund the infrastructure projects. Under the extra budget, JPY713.7bn will be used to enhance welfare measures including supporting childcare and distributing cash to low-income earners to boost consumer spending. Another JPY1.41tn will be set aside for infrastructure improvement to attract foreign tourists to Japan and promote agricultural exports. The government also intends to increase low-interest government loans – zaito – by JPY1.5tn to bring forward the launch of the high-speed maglev train services between Tokyo and Osaka from 2045 and another JPY828bn to accelerate construction of shinkansen bullet train lines on other

routes. The extra budget is expected to be debated and passed in a special session of the Diet sometime in mid-Sep. Thereafter, the earliest the fiscal package will be operational will be in Oct.

- The current account surplus narrowed to JPY0.97tn in Jun from JPY1.81tn due to a drop in the primary income surplus to just JPY0.42tn (from JPY1.90tn in May) that offset the JPY0.60tn surplus in the goods and services account. The financial account surplus also narrowed in Jun to JPY1.45tn from a drop in inflows, both FDI (+JPY0.34tn) and portfolio (+JPY3.0tn), in Jun that offset the narrower outflow in the other investment account (of -JPY1.25tn). Consequently, the overall balance of payments surplus narrowed to JPY2.90tn in Jun from JPY8.20tn in May.
- **Key domestic events and issues to watch:** Final GDP print for 2Q will be released on 8 Sep. The BOJ meets on 20-21 Sep and a presser by BOJ governor Kuroda will follow. An extraordinary session of the Diet (parliament) is expected in mid-Sep to pass the extra budget for fiscal year 2016. BOJ governor Kuroda speaks at a Kyodo News event on 5 Sep and in Osaka on 26 Sep. BOJ deputy governor Nakaso speaks in Tokyo on 8 Sep. JGB auctions in Sep: 10-year (1 Sep), 30-year (6 Sep), 5-year (8 Sep), 20-year (13 Sep) and 1-year (14 Sep).
- **Technical Outlook:** Weekly and daily momentum indicators are showing tentative signs of turning bullish, as of writing. Pair was last seen at 102.30 levels. Move above 102.90 (50 DMA) puts next resistance around 105 levels (upper bound of the bearish trend channel, 100 DMA). Support remains at 101.20 (21 DMA), 99.50 (interim low for 2016).

CNY: Holding On To That Sweet Spot

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/CNY	6.65 --	6.67 --	6.70 --	6.70 --
USDCNH	6.67 --	6.69 --	6.71 --	6.70 --

No Change From Previous Forecast

- **Motivation for the FX View:** The revival of Fed hike expectations within 2016 also awakened the yuan bears. That reinforced the correlation that we have been watching. We still hold the view that in a period of strong expectations for Fed to hike, CNH and CNY will strengthen against the basket (non-US trading partners). This is the moment of stress that PBoC has been preparing the CNY for. As of Jul, China's REER has corrected 7% from its high in Feb. So by that definition, the yuan is more competitive and more fundamentally aligned for an economy that is undergoing a period of weakness and restructuring. To be honest, the Fed is helping by assuring markets that rate normalization will be super gradual and Yellen went as far as saying that "*forecasts show the federal funds rate settling around 3% in the longer run (vis a vis >7% in 1965-2000) and she expects less scope for interest rates cuts in the future compared to the past*". That is Fed's way of retaining that sweet spot for EM including China. What have we noticed since Jackson Hole? USDCNH revisited the

6.70-level but a stronger-than-expected yuan fixing spurred markets into selling the pair again. Yes, the 6.70-level is still seen as the line to be defended by PBoC for now ahead of key events like the G20-Summit in Sep and the official SDR inclusion on 1 Oct. Hence, we hold on to our USDCNY forecast at 6.65 for 3Q before a creep back towards 6.70 by 1Q next year.

- Just a recap to make sense of what PBoC is doing. We think PBoC has been getting CNY to be more aligned with its "fundamentals" in the hopes that when markets start to price in a Fed hike, CNY would not come under as much pressure as before. A more market-determined yuan would make room for capital account liberalization and eventual inclusion in global indices. With a sustained current account surplus, there is a reasonable buffer for CNY weakness against the USD.
- Has it worked? USDCNH 1M and 3M Vols have risen back to Jul highs but 6M and 1Y vols have not seen the same magnitude. All in all, the rise in vols is hardly the kind that we saw earlier this year. Markets are still somewhat calm. First, this shows that upside pressure on the USDCNH may not be as acute and intense as before. Second, this underscores the correlation that we have been noticing since Brexit that the yuan is not directly correlated to DXY index, rather the yuan is correlated to expectations of Fed hike.
- We see two scenarios ahead. 1) Fed hike in Sep - a dovish hike and be done for the rest of the year; 2) Fed has a hawkish hold in Sep before making a dovish hike in Dec. The first scenario would probably see rise in the USDCNH before it comes off. The second scenario could see USDCNH making a shallow correction after Sep before heading higher again. We are more biased towards the latter and hold our 3Q USDCNY forecast at 6.65, USDCNH at 6.67.
- **Our monthly Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) showed the score for China has deteriorated to 5.4 from previous 4.7 (with 1 being the best and 9 being the worst) due to a deterioration in its current account and fiscal deficit.
- **Growth and inflation outlook:** China saw a jump in the Caixin PMI-mfg to 50.6 from previous 48.6 which is a contrast to the slight deterioration in the official (NBS) PMI-mfg to 49.9 from 50.0. The breakdown of the NBS PMI-mfg shows that smaller and medium firms seem to be registering more contraction than the larger firms. This paints a picture of SoEs still under pressure while private manufacturing firms are reporting higher production and acceleration in new orders, as reported by Caixin-Markit. This suggests that supply side reforms are taking effect and there are pockets of domestic demand picking up.
- **China is still focused on achieving growth stability, yuan stability and deleveraging with stability.** It will not be easy. All three activity prints missed expectations. Jul industrial production slowed to 6.0%y/y from previous 6.2%, weighed by a contraction in natural gas output and coking coal as well as a slowdown in the output of processed crude oil and cement. Retail sales also underwhelmed with a print of 10.2%y/y vs. previous 10.6%. The deceleration was broad-based with the exception of garments, cosmetics, furniture and construction materials. Urban FAI was the shocker, at 8.1%y/y vs. previous 9.0% as investment in the over-capacity sectors including smelting & pressing, mining and dressing, railway transportation saw deep contractions as the impact of supply side reforms start to come

through. Industrial profit rose in Jul to 11.0%y/y from previous 5.1%. We were dismay to see that profitability improved more in the sectors with excess capacity compared to those that are not. As such, this improvement is nothing to celebrate.

- We think supply side reforms might have started to affect the services sector. Investment spending was weak across the board including the tertiary sector. PMI services deteriorated to 51.7 from 52.7. We closely monitor the retail sales for a better sense of private consumption. However, recent property prices suggest that there has been better take-up in tier 3 cities which reflects progress on the urbanization front and improvement in terms of long term growth.
- Inflation softened to 1.8%y/y for Jul from previous 1.9% on lower food costs. This was surprisingly given the fact that China experienced floods in the past few months and we had expected food cost to rise, especially that of pork. PPI saw a smaller contraction of -1.7%y/y compared to previous -2.6%. NDRC had expected a modest rise in CPI to could temper the decline in PPI in 2H. We continue to watch this space.
- **We are cautiously optimistic about the economic data so far and continue to expect liquidity support for the old and new economies in China**. Home mortgage loans continued to rise in 1Q on the back of easy monetary conditions. Macro prudential measures should remain in place in the tier-one cities. The growth in the real estate sector should continue to have positive spillover effects in mining, construction, consumer goods and real estate services. There has been some rumours of officials firming up the debt-to-equity swap plans. As usual, the devil is always in the details and could be the difference between deleveraging and greater moral hazard and risky loans.
- **Monetary Policy:** Weak economic outlook warrants further easing but its impact on the CNY is a constraint. That does not mean that PBoC is not going to keep monetary conditions accommodative. The central bank will use pledged supplementary lending, medium term lending facility and standing lending facility to supply credit to the targeted sectors that require more liquidity support. Broad based RRR cuts may risk generating flows to assets that are prone to bubbles (real estate in the tier-one property sectors), undo deleveraging efforts in the economy and increase downside pressure on the CNY.
- Jul saw more liquidity boosts via the medium term lending facility, about CNY486mn vs. Jun's CNY208mn. An estimated CNY 254bn of liquidity was also injected via open market operations. That was likely to bring down the 7-day repo rates which spiked above 3.00% on 19 Aug. Rates are now back to the 2.4%-level as we write. It has been a month of two halves for China sovereign curve. The curve steepened in the first half of the month and started to flatten towards the end of Aug. The re-introduction of the 14-day reverse-repo on 24 Aug came amid rumours that the central bank want to discourage short-term borrowing to fund bond purchases. 14-day repo rate surpassed 7-day repo rate at one point but both have come off as we write. PBoC demonstrates its role as a liquidity backstopper.
- **Latest Fiscal and External Balance Outlook:** There has been some estimates floating around that the budget deficit for 2015 was three times the official print at 10% of GDP in 2015. Official statistics have shown that growth of government expenditure is still likely to head higher as the government works to pump prime the economy with infrastructure investment. The recent tax overhaul which moves construction, property, finance and consumer service sectors under

the value-added structure could mean less revenue for the local governments. The central government plans to increase budget deficit to redistribute the VAT revenue back to provinces. Small businesses with less than CNY500,000 in annual sales will drop to 3% from 5%.

- Current account surplus widened to U$59.4bn from previous U$39.3bn in the quarter prior. The outflow via its capital accounts was much lower at -U$30mn vs the previous -U$112.2mn amid capital account controls. The latest release of BOP for 1Q 2016 show that there has been capital inflow via trade credit, deposit and currency in the period. Loans outflow has resumed in the first quarter of the year, suggesting that banks are lending to overseas entities. We expect outflows to resume this month but existing capital control and a lack of aggressive fed tightening suggest that outflows should be manageable.
- **Key domestic events and issues to watch:** PMI-mfg and non-mfg are due on the 1st along with Caixin PMI-mfg. Foreign reserves is scheduled for release on the 7th. Trade is due on the 8th. CPI and PPI on the 9th. Liquidity prints are due anytime from 10th-15th. Activity data is due on 13th. Property prices are eyed on the 19th. We also like to watch Jun industrial profits due on the 27th. Caixin PMI-mfg for Sep is due on the 30th, along with the final print of the 2Q current account balance print.
- **Technical Outlook:** Weekly chart is bearish on the USDCNH. A deeper correction seems to be required for USDCNH to continue its uptrend. Support is seen around the 6.60 before the 50-DMA at 6.53. Barrier is still seen around the 6.70 before the 6.7620.

KRW: Gains Likely to Be Tempered

Forecast	3Q 2016	4Q2016	1Q 2017	2Q 2017
USD/KRW	1125 (1165)	1170 (-)	1180 (-)	1180 (-)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Recent gains in KRW are expected to slow in coming days, post Jackson Hole (26 Aug) which somewhat saw a rise in UST yields, USD and led to decline in risky assets including equities as well as most EM currencies. We think USDKRW may have some upside to run (possibly towards 1140 level) over the coming days as markets re-adjust position in the lead-up to FoMC meeting in Sep. We also expect trading activity to pick up, FX vols to return and as a result, less one-way directional trade over the coming 2-3 weeks.
- That said, we expect this run-up to be temporary. We do not think Fed will eventually raise interest rates at their FoMC meeting on 21 Sep (our house view remains for Fed to hike after Presidential Elections in Nov) and post-market reaction of the FOMC meeting (assuming no hike) is expected to bring about relief rally in risky assets. Sentiment should recover, and KRW could pare back losses. This is on the basis of easy monetary conditions globally with a potential delay in Fed tightening amid subdued global growth and low inflationary expectations.

- Over the past 1 month, KRW had a Bull Run vs USD, breaking below 1,100 and traded near 15-month low of 1092 (10 Aug). KRW gains were due to a combination of factors including strong inflows into Korean equity and bond markets, recent S&P upgrade on South Korea's credit rating to AA (from AA-), JPY gains in absence of fresh monetary stimulus, and broad USD weakness.
- S&P raised its long-term sovereign credit rating on South Korea by one notch to AA, from AA-, while keeping its outlook on the rating at 'Stable'. According to the S&P's statement (8 Aug), the upgrade is a reflection of Korea's strong record of steady growth that has generated a prosperous economy, greater fiscal and monetary flexibility, and continual improvements in external conditions; reduction of short-term external bank debt and persistently large trade balances strengthened Korea's external metrics, which also enhance the sovereign's credit quality. It also added that a recovery in the US economy should provide support for Korean exports, partly offsetting weaker exports to China.
- This is the second rating upgrading in 11 months after S&P first revised South Korea's rating by one notch in Sep 2015. S&P's "AA" rating is third highest in S&P rating and is now in line with Moody's rating of Aa2 (which was revised up in Dec 2015). This is the highest credit rating that South Korea has ever received from S&P. And we believe this is a positive for Korean bonds, and should keep the KRW supported.
- Taking into consideration the factors above and the recent price action, we revise lower our 3Q forecast towards 1125 and continue to keep our USDKRW trajectory over the forecast horizon.
- Risk to our outlook: USDKRW could re-test above 1160 levels if US data over the coming weeks surprise to the upside leading to a hawkish 25bps hike by the Fed in Sep. On the other hand, if Fed indeed chooses not to hike and followed up with dovish statement, we think this could spark off a risk-on party and lead to renewed USD downside. A move below 1100 cannot be ruled out on this scenario.
- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for S.Korea improved to 6.1, from 6.6 in previous month due to improvement in fiscal.
- **Growth and Inflation Outlook:** BoK noted that while exports have been on a decline, domestic demand activities including consumption continued to see moderate improvements. Sentiment indicators have also improved while employment to population ratio rose.
- 2Q GDP accelerated +0.7% q/q; +3.2% y/y, better than previous quarter of +0.5% q/q and +2.8% y/y. Expansion was helped by private consumption and construction. We believe the growth momentum for 2H may slow on corporate restructuring plans which are expected to see some short term pain due to job cuts, impacting growth.
- BoK had earlier lowered 2016 GDP growth to 2.8% (from 3%) and inflation forecast to 1.2% (from 1.4%), due to weaker than expected domestic economic growth in 1Q 2016 and downward revision to global economic growth.
- Jul headline inflow fell slightly to 0.7% y/y (from 0.8% in Jun), owing to a slowdown in the rate of increase in service fee. Core inflation was also slightly softer at 1.6% y/y (vs. 1.7% in Jun).
- **Monetary Policy Forecast**: We expect BoK to keep policy rate on hold at record low of 1.25% for the third consecutive time at the 9 Sep

meeting. We believe BOK will wait and hold for the monetary stimulus effects (25bps cut in Jun) to work its way into the real economy, before deciding whether it is necessary to cut rate so aggressively.

- **Latest Fiscal and External Balance Outlook:** Current account surplus widened to record levels of $12.17bn in Jun, from $10.36bn in May due to the increase in trade surplus (as a result of falling imports). This was the largest surplus in 2016 and longest monthly current account surplus for 52 months. IMF has recently pointed out that South Korea's current account surplus is excessive
- According to the Public Finance 2015 report issued by National Assembly Budget Office, fiscal deficit for 2016 is expected to widen to -2.3% of GDP. Sovereign debt to GDP is expected to climb to 40% of GDP for 2016.
- **Key domestic events and issues to watch:** S. Korea releases Aug exports, CPI, and Jul current account data (1 Sep); 2Q GDP (2 Sep); BoK meets (9 Sep) and Jul IP (30 Sep).
- **Technical Outlook:** USDKRW made a multi-month low of 1091 (10 Aug) before rebounding higher. Last seen at 1125 levels. Daily and weekly momentum indicators suggest some upside risks. 1127 presents the first level of resistance on this technical rebound (neckline of the H&S pattern and also the 50% Fibonacci retracement of 2014 low to 2016 high) before 1140. Bias remains to sell on rally targeting 1064 medium-term objective (76.4% fibo retracement of 2014 low to 2016 high) - head and shoulders pattern on the weekly chart with Head (or "H") at 1244.90, Shoulder 1 (or "S1") at 1208.70 and Shoulder 2 (or "S2") at 1199.65 levels.

SGD: Downward Trajectory Remains Intact

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDSGD	1.3650 (1.3600)	1.3750 --	1.3800 (1.3900)	1.3850 (1.4000)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** Over the past month, the SGD switched from strength to weakness, largely tracking the USDJPY movements. Initial softness in both the USDJPY and the dollar has since given way to firmer tone. Expectations of further easing measures in Japan as well as increasing risk that the US Fed could resume hiking interest rate sometime this year are supportive of the USDSGD. So far in Aug, the SGD has fallen by 1.6% against the USD. Despite this bounce higher, the SGD is still up 4.1% against the USD year-to-date.
- The re-pricing of a Fed rate hike in 2016, possibly even in Sep, has led to some unwinding of long-SGD positions. At the same time, the climb in the UST 2-year bond yields back above the 0.8% levels is also putting upside pressure on the USDSGD, given its negative correlation with the SGD. At the same time, the strong correlation of the USDSGD to the USDJPY suggests that further USDJPY upside could lift the USDSGD higher as well. Consequently, the pair has bounced back

above the 1.36 levels from the 1.34-1.35 levels at the point of writing.

- Still, this is unlikely to lead to an overly aggressive bounce in the pair. While detailed breakdown of foreign portfolio flows is not available, an examination of government debt yields provides some insights. Yields across the curve have remained lower by 0.9-9.0bp so far in the month, suggesting that there remains some foreign demand for government debt. This is not surprising given its triple-A status. As well, the persistent balance of payments surpluses could moderate the pair's climb higher from current levels.
- Domestic challenges though continue to persist. Consumer spending remains muted with private consumption decelerating to 3.2% in 2Q vs. 4.2% in 1Q. Consumer confidence is on the wane on the back of rising unemployment amid ongoing economic restructuring and weak property prices. As well, muted global growth is weighing on export-oriented industries.
- Nonetheless, higher government spending of SGD5bn in FY2016, higher than FY2015's total spending, should help to prevent the economy from sliding below the lower bound of the government's 1-2% growth forecast range for 2016. Growth gains are thus likely to be more modest than its regional peers, coming in at 1.8% in 2016 and 2017.
- While there is the possibility of a MAS move in Oct, this is not our base scenario for now. We expect the current neutral policy stance of the MAS to be maintained for the rest of the year, unless there is a significant deterioration in the global economy or shift in the core inflation outlook. Standing pat on policy should be supportive of the SGD and keep the USDSGD from rising too rapidly.
- The USDSGD remains on an upward trajectory, supported by both domestic and external challenges. We have however revised our forecast slightly higher to reflect the pull of the UST 2-year yield and the USDJPY in 3Q but have moderated the trajectory ahead. We continue to favor buying on dips. We now expect the USDSGD to climb towards the 1.3850 levels by the end-1H 2017 as expectations of further Fed rate hike in 2017 remain intact. We will re-assess our calls and levels should the pair break decisively above the 1.3800 resistance on a monthly close basis.
- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Singapore improved slightly to 4.3 from the previous month's 4.4. This was due to an improvement in current account and reserves risks that offset the deterioration in fiscal risk. This should be supportive of the intrinsic value of the SGD. Our model shows that the SGD NEER was last seen 0.08% below the mid-point implied at 1.3613. Upper bound is implied at 1.3341 while lower bound is now at 1.3885.
- **Growth and Inflation Outlook:** The economy expanded by 2.1% y/y in 2Q16, the same pace as in 1Q. However, this was a mild downward revision from the flash estimates of 2.2% and could be attributed to the slower growth in the services sector. Services rose by 1.4% y/y in the final estimates for 2Q vs. 1.7% in the advanced estimates. However, it was not all bad news. Manufacturing was revised higher from the preliminary estimates of 0.8% to 1.1% in the final print. With the global economic outlook still cloudy, the government has narrowed its 2016 forecast range to 1-2% from 1-3% previously, barring the full materialization of downside risks. This suggests that

the government expects growth in 2H16 to slow to -0.1% to 1.9% given that 1H growth averaged 2.1%. Our economic team expects growth to come in at 1.8% for both 2016 and 2017.

- Disinflationary pressures continue to persist. Headline inflation fell by 0.7% y/y in Jul, the same pace as in Jun, still pressured lower by falling housing and transport cost. Accommodation cost fell by 4.3% y/y while transport cost slipped 3.5% y/y in Jul. MAS core inflation (CPI ex-accommodation and private transport) was little changed from Jun at 1.0% y/y as services inflation was unchanged at 1.6%. The MAS outlook for headline and core inflation was maintained with the former expected to come in at -1.0-0.0% in 2016 and the latter to average around 1.0%. MAS expects headline inflation to return to positive territory and move towards 1.0% in 2017. Our economic team maintains its headline inflation to average -0.4% in 2016 and expects core inflation to come in at +1.0% in 2016 as disinflationary effect of oil and budgetary and other one-off measures fade.
- **Monetary Policy Forecast:** The weak outlook for domestic and global growth in 2H has raised some expectations that the MAS could ease policy (i.e. recentering lower) even lower at its Oct meeting. The risk of an MAS move in Oct remains positive but is not significant for now. Our base scenario remains for the MAS to maintain their “zero appreciation of the SGD NEER” stance. The monetary authority had progressively removed the crawl as there was no need for an appreciation path on balance and the medium term path is closer to a constant now than upward sloping given current domestic and external conditions. Unlike past occasions when the slope was flattened swiftly, the recent change in the slope was more gradual and in response to the slow drift to inflation. In the short term, in absence of significant shocks, an adjustment to the NEER band would be unnecessary.
- There have so far been no significant changes to the MAS’ expectations for growth and core inflation, even though the growth forecast was narrowed to a tighter range. The likelihood that the MAS would contribute to financial market volatility by creating any policy-driven volatility remains slim. Aside from global growth concerns, post-Brexit concerns form the bulk of the headwinds to domestic growth uncertainties. However, MTI expects the Brexit impact on the domestic economy to be modest in the medium- to long-terms. Moreover, Deputy PM Tharman noted that Brexit is not expected to result in a significant reduction in Singapore's growth in the next few years, but he did flag that there could be a "more major impact" if events in Europe coincided with a sharp slowdown in China and the US. Thus, there is unlikely any significant external risk events to trigger a MAS response in Oct at the moment. With MAS standing ready “to curb excessive volatility”, a widening of the policy band does not appear to be in the card at the moment as well.
- The risk of another move in Oct is likely to increase should disappointing data, especially those for 3Q (including revisions to 2Q GDP and Jul industrial production print), threaten the MAS’ assumption for growth and core inflation. In the unlikely event that these risks materialize, we could expect the next move by the MAS to be a downward re-centering of the SGD NEER. Nevertheless, while the hurdle for further policy adjustments have been lowered with the policy adjustment in Apr, we expect the MAS to stand pat at its Oct meeting unless barring the materialization of risks to its assumptions for growth and core inflation.

- In the past month, the USDSGD has been on the bounce back above the 1.36 levels from the 1.34 levels but this has not resulted in large swings to domestic interest rates. In fact, domestic interest rates have been on the slide in Aug. The 3-month SIBOR (3MSIBOR) has come off from 0.8759% at the beginning of the month to hover around 0.8719% currently. The 3-month SOR (3MSOR) has fallen by an even faster pace in Aug from 0.8439% on 1 Aug to 0.7078% currently. Year-to-date, the 3MSIBOR and 3MSOR have fallen by over 30% and almost 60% from its Jan high of 1.254% and 1.76235% respectively. The relatively low rates suggest that the rise in mortgage rates is unlikely to be significant for now. Deposit rates (for 12-month fixed) have not risen since end-Jan and remains at around 0.35% currently. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, seems limited for now.
- The recent re-pricing of a Fed rate hike in 2016 suggests that there could be upward pressure on domestic rates. Already, US 3MLIBOR is on the uptick since the beginning of the month. US 3MLIBOR has risen by nearly 10% to 0.8334%. Ample liquidity has so far kept domestic rates from tracking the US 3MLIBOR higher. However as the US resumes its rate hike, domestic rates should eventually start their slow grind higher, especially as liquidity conditions tighten. We continue to expect the 3MSIBOR and 3MSOR to end 2016 and 2017 at 1.49% and 1.30% and 2.24% and 2.05% respectively.
- **Latest Fiscal and External Balance Outlook:** The current account surplus widened to SGD20.85bn in 2Q 2016 from SGD18.85bn in 1Q. The larger current account surplus could be attributed to the larger surplus in the goods and services account of SGD27.63bn (1Q: SGD24.45bn) that offset the increase in the primary balance account deficit of SGD6.78bn (1Q: -SGD5.60bn). The financial account surplus narrowed to USD15.78bn (1Q: SGD26.90bn) as portfolio inflows (2Q: USD25.04bn) and smaller 'others' segment (2Q: SGD26.22bn) that offset the larger outflow of direct and financial derivative investment (2Q: -SGD14.68bn and –SGD9.80bn respectively). The overall balance of payments returned to a surplus of SGD4.76nm in 2Q 2016 compared to SGD8.72bn in 1Q.
- **Key domestic events and issues to watch:** There are no notable events for Sep.
- **Technical Outlook:** USDSGD appeared to have formed an interim base around 1.3350 (2016 low). This level has been tested about 4 times this year (Apr, Jun, and twice in Aug). Daily/ weekly momentum and stochastics indicators are pointing to further upside. Persistent close above 1.3610 (23.6% fibo retracement of 2016 high to low) could see a move higher towards 1.3770 (38.2% fibo, 200 DMA). A stretch towards 1.39 (50% fibo) cannot be ruled out. Support at 1.3550 (100 DMA), 1.34 levels.

MYR: Extended Weakness before Strength

Forecast	3Q 2016	4Q 2016	1Q2017	2Q2017
USD/MYR	4.0000 --	4.0000 --	3.9500 --	3.9500 --

No Change from Previous Forecast

- **Motivation for the FX View:** Over the past 1 month, MYR was relatively flat, even as oil prices fell and rose, USD weakened and then strengthened recently, and despite still ongoing concerns about domestic idiosyncratic risks.
- USDMYR traded as high as 4.0683 (3 Aug). This was well within the range of 3.98 – 4.14 we called for, over the past few months. And we think this weakness could still persist in the short term but solid underlying fundamentals and policies {backed by domestic demand, re-calibrated budget (on a lower oil price assumption suggests flexibility in the fiscal space), relative stability in oil prices though some downside pressure, relative attractive yields in the MGS, stabilizing ratio of 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 subsided.
- We note that **oil prices may face some downside pressure in the near term as refiners have already finished stocking for the summer (now to Oct) season. On the big picture, oil supply-demand is projected by EIA to rebalance further over the next 1 year. Oil surplus supply is also winding down due to the lack of capex in the last 18 months while seasonal demand for winter in 4Q should see oil prices picking up.** We still expect oil prices to see support around $40-42/bbl. Hence it is **not our baseline scenario to see MYR suffer another round of high-single digit rout** (in 3Q 2015 – end-2015).
- We do expect to see broad but modest USD strength into 2H 2016, as we head into US Presidential Elections in Nov (which typically saw USD strength in the lead-up and post-Elections). Some post-*Brexit* uncertainty (on timing of trigger of Article 50, trade talk negotialtions with EU and other trade partners) is also expected to weigh on sentiment and keep the USD modestly supported. Risk of potential Fed rate hike in Dec 2016 (now our base case scenario with some risk of a Sep hike first) could also see a firmer USD in the lead up to 22 Sep FoMC meeting. While all the above factors (Presidential Elections, *Brexit uncertainty and Fed rate hike)* may keep the USD supported, investors' hunt for attractive yields could continue to see inflows into local bond markets and counteract to support the MYR, mitigating the upside pressure in the pair.
- We continue to caution for USDMYR to trade in wide ranges. 4.15/4.20 should keep the lid on USDMYR (assuming that oil prices do not fall more than 15%) while downside towards 3.95 should not be ruled out for the month. We maintain our FX forecasts over the forecast horizon, but slightly lower USDMYR forecast for 3Q to 4.00.

- **Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.55 levels.** We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We still expect to see some stability returning to Ringgit as political/contingent liability risk subsides, fiscal consolidation/reforms gains traction, oil prices stabilize and uncertainty and likelihood of Fed rate hike subsides for the next 6 months.
- External reserves as of 15 Aug 2016 rose USD0.2b to USD97.5b (MYR391.9b) from USD97.3b (MYR391.1b) as at end-July 2016, the highest sub-USD100b level so far. The latest count covers 8.1 months of retained imports and 1.2 times of short-term external debt.
- There was sustained foreign net buying of Malaysian equities with the latest data showing foreigners were net buyers of Malaysian equities so far in Aug 2016 (1-22 Aug), totaling +MYR1.5b, sustaining the +MYR1b net buying in July 2016. Meanwhile, in July 2016, foreigners bought a net +MYR5.7b of Malaysian debt securities, also sustaining the same amount of net buy in June 2016, in turn pushing up the foreign holdings of Malaysian debt securities to 20.9% of total outstanding in Jul 2016 from 20.3% in June 2016.
- The net foreign buying in Jul 2016 was supported by higher net buys of GII (Jul 2016: +MYR 2.6b; June 2016: +MYR 2.1b) and sustained net buys of MGS (Jul 2016: +MYR 3.2b; June 2016: +MYR 5.0b), in turn pushing up the shares of foreign holdings of total GII and MGS to record highs of 10.6% (June 2016: 9.5%) and to 51.9% (June 2016: 9.5%) respectively. This was despite the maturity of MYR10.4b MGS and MYR4b GII in July 2016. Therefore, the net buying in July 2016 point to full rollover of matured MGS and GII plus additional purchases of those debt instruments.
- The trends in external reserves and the **foreign net buying of Malaysian debts and equities are in line with the rebound in portfolio capital flows into the Emerging Markets (EM),** which jumped to +USD24.8b from +USD13.3b and –USD12.2b in May. This indicates return of "risk on "mode" following, among others, the US Fed's decision to leave its benchmark interest rate unchanged at the June FOMC, in contrast to the "hike rhetoric" that was prevalent during May 2016, followed by expectations that US rate hike is increasingly unlikely this year. The question is how long this will be sustained.
- **Our monthly Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Malaysia improved to 4.9 in Jul (vs.5.2 in June), due to owing to inflation and improvement in the current account. Malaysia's current account surplus narrowed in 2Q 2016 to MYR1.9b or +0.6% of GDP (1Q 2016: +MYR5.0b or 1.7% of GDP) on smaller goods account surplus and wider income account deficit but as we calculated the score on a relative basis, the improvement suggests that other current account in Asia fared worse than Malaysia. Our economics team full-year forecast for the current account is +MYR24.3b or 2.0% of GDP.
- **Growth and Inflation Outlook:** 2Q 2016 GDP growth slowed to +4.0% YoY and seasonally-adjusted +0.7% QoQ (1Q 2016: +4.2% YoY; +1.0% QoQ SA), in line with our and consensus estimates. Broad-based pick up in domestic demand negated the contraction in net external demand. No change in our 2016 and 2017 growth forecasts of +4.1%

and +4.5% for now as we closely monitor key domestic indicators and developments in major economies.

- Domestic demand picked up (2Q 2016: +6.3% YoY; 1Q 2016: +3.6% YoY) on faster growth in all components i.e. private consumption(2Q 2016: +6.3% YoY; 1Q 2016: +5.3% YoY), public consumption (2Q 2016: +6.5% YoY; 1Q 2016: +3.8% YoY) and gross fixed capital formation (2Q 2016: +6.1% YoY; 1Q 2016: +0.1% YoY), which reflected firmer private investment (2Q 2016: +5.6% YoY; 1Q 2016: +2.2% YoY) and rebound in public investment (2Q 2016: +7.5% YoY; 1Q 2016: -4.5% YoY).
- Net external demand was a drag (2Q 2016: -7.0% YoY; 1Q 2016: -12.4% YoY) as import growth (2Q 2016: +2.0% YoY; 1Q 2016: +1.3% YoY) outpaced export growth (2Q 2016: +1.0% YoY; 1Q 2016: -0.5% YoY). Another drag on GDP growth last quarter was "change in inventory" which turned negative (2Q 2016: –MYR1.1b; 1Q 2016: +MYR2.4b), indicating inventory drawdowns or corrections, namely in the consumer-related manufacturing industries and the agriculture sector amid the slump in palm oil output.
- Growth picked up in services, mining and construction amid slower manufacturing and deeper decline in agriculture.
- Our Economics team sees no change in our 2016 full-year forecast of +4.1% (1H 2016: +4.1%), implying growth is expected to hover at just over +4.0% in 2H 2016. The projection for 2017 also remains at +4.5%.
- At this juncture, we need to keep a close tab on key high frequency domestic data, namely the monthly economic indicators such as the indices on industrial production and distributive trade, external trade, money and banking statistics, as well as major commodity output and prices. In addition, our eyes are also on the economic trends as well as policy and political developments in the major economies i.e. US, Europe (including UK), China, Japan.
- **Headline inflation rate eased further** to +1.1% YoY in Jul 2016, amid broad-based easing in CPI components, while core inflation was relatively stable at +2.0% YoY (June2016: +2.1% YoY). YTD 2016 inflation is +2.4% YoY while core inflation at +2.7% YoY. Our economics team is revising our 2016 inflation rate forecast range to 2.0%-2.5% from 2.3%-2.8%. The range forecast reflect various factors such as the volatile currency and commodity prices-especially crude oil prices; weather and seasonal effects on food-related commodity and food prices e.g. surge in world raw sugar prices impacting domestic sugar prices; scheduled reviews and the still-pending decisionson "administered prices" like gas and electricity tariffs, PLUS highway toll rates and Indah Water sewerage charges; cost impact of specific domestic labour market policies, such as the hike in levy on foreign workers effective 18 Mar 2016 (Peninsula Malaysia for now) and the Minimum Wage increase on 1 July 2016; and extension of the Price Control & Anti-Profiteering Act to 31 Dec 2016 from 30 Jun 2016, which helps to reduce the risk of excessive price hikes, although pass-through of cost increases and price increases could be more prevalent next year.
- The moderation in CPI reflects base effect last year as inflation accelerated following GST introduction in Apr 2015 as well as higher domestic fuel prices in Jul 2015 amid the broad-based easing in major CPI components in Jul2016. Compared to June 2016, both headline and core inflation rates edged up by +0.3% MoM and +0.1% MoM respectively. Year-to-date, headline and core inflation rates were +2.4% YoY and +2.7% YoY respectively.

- As Jul 2015 was the month with highest CPI inflation for 2015 at +3.3% YoY, the base effect means that the +1.1% YoY inflation rate for Jul 2016 could well be the lowest monthly inflation rate for 2016 i.e. we do not expect it to go lower for the rest of 2016.
- **Monetary Policy Forecast:** At the last BNM MPC meeting on 13 Jul, the **BNM lowered OPR by 25bps to 3% while keeping the SRR unchanged at 3.5%.** We see this cut as a pre-emptive cut in light of BNM's concerns on possible downside risk to global and domestic growth. A moderation in CPI prices also provided a window of opportunity.
- In particular, BNM highlighted *"Global growth prospects have also become more susceptible to increased downside risks in light of possible repercussions from the EU referendum in the United Kingdom. International financial markets could also be subject to greater volatility going forward."*.
- Our Economics team interprets the MPS to be "dovish" in nature, as BNM sees (1) downside risks to global and domestic growth post-Brexit - in particular Malaysia exports are projected to remain weak following more subdued demand from key trading partners; (2) no upside risk to inflation, given that BNM lowered its inflation projection for 2016 and sees stable prices for 2017, implying no upside risk to inflation; (3) risk of destabilizing financial imbalances have receded as macro and micro prudential measures, as well as supervisory oversight, have resulted in more prudent lending.
- Our Economists wrote – "Granted that 25bps is not that much to move the needle, it **helps sentiment and confidence** by sending signal that BNM is "risk aware". The immediate impact is to **provide some relief to businesses and individuals by lowering their debt-servicing costs.**"
- Our Economists are also pricing in the **possibility of another 25bps cut over the next 6 - 12 months,** but **do not expect rapid-fire OPR cuts over the next few meetings as BNM turns "risk aware", "data-dependent" and "event-driven".**
- **Latest Fiscal and External Balance Outlook:** According to the latest revised budget (released 28 Jan), the government aims to maintain its 2016 fiscal deficit at 3.1% of GDP via a series of restructuring steps (operating and development expenditures cuts) that are expected to save the government MYR9bn. Malaysia's fiscal and broader economic outlook could still be under pressure from weaker commodity prices in 2016. **The revised Budget has adjusted lower its oil price assumption to US$30-35/bbl (from $48/bbl).** Downside pressure on rating agencies' 'Stable' outlook could arise in 2H 2016 if oil price averages below US$30/bbl as that may trigger projection of fiscal revenue shortfall.
- Exports in June 2016 rebounded by +3.4% YoY (May 2016: -0.8% YoY) while import growth quickened to +8.3% YoY (May 2016: +3.1% YoY), resulting in wider trade surplus of +MYR5.52b (May 2016: +MYR3.3b). Faster import growth relative to export growth in 2Q 2016 resulted in narrower trade surplus in 2Q 2016, implying net external demand was a drag in 2Q 2016. Our economics team expects external trade condition to remain challenging in 2H 2016.
- World trade performance remained sluggish in May 2016 as volumes grew by +0.8% YoY (Apr 2016: +0.4% YoY) according to data published by Netherlands Bureau for Economic Policy Analysis, while our Economics team measure of global trade values in USD remained underwater at -3.0% YoY (Apr 2016: -3.5% YoY).

- Exports volumes saw a divergent performance as ‘Advanced Economies’ were dragged down by declines in shipments from US and Eurozone which offset the strong rebound in Japan’s exports. ‘Emerging Economies’ registered slower growth as expansions in exports from ‘Latin America’ was tempered by declines in exports from ‘Emerging Asia’.
- **Key domestic events and issues to watch:** Trade data (7 Sep); FX reserves (6 Sep); BNM MPC policy (7 Sep); CPI Inflation (21 Sep).
- **Technical Outlook:** USDMYR traded higher into end month, as we write amid re-pricing of expectation for Fed rate hike in Sep. Pair was last seen at 4.0550 levels. Weekly, daily momentum is turning mild bullish bias. Next resistance at 4.0720 (38.2% fibo retracement of 2016 high to low). Break above on daily/weekly close puts 4.1070 (200 DMA) before 4.1420 (50% fibo). So long this resistance holds, we think the upside should be capped. But a push on weekly close beyond this key resistance puts 4.21 (61.8% focus) in focus. Support at 3.9850 (23.6% fibo).

IDR: Near-Term Risks, Medium-Term Gains

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDIDR	13200	13300	13200	13200
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No Change From Previous Forecast

- **Motivation for the FX View:** The positive sentiments that had kept the USDIDR buoyant in Jul was short-circuited in Aug. Rising expectations of a Fed fund rate hike in 2016 spurred some portfolio outflows that has weighed on the IDR. Consequently, the IDR has weakened by 1.2% against the dollar so far in Aug. Despite this weakness in Aug, the USDIDR is still up vs. the dollar in 2016. Year-to-date, the IDR is up 3.8% against the USD as the search for yields had lifted foreign demand for Indonesian equities and government debt.
- The positive sentiments from the implementation of the tax amnesty law which came into effect on 11 Jul, the improving macroeconomic fundamentals, government commitment to reforms, fiscal stimulus packages, accommodative monetary policy and greater political stability continue to underpin the IDR. These factors should keep the USDIDR from climbing even higher beyond the 13300 in the next three-to-six months.
- So far, 13 stimulus packages have been introduced aimed at cutting red tape, liberalizing rules that have been a drag on investment and growth, and supporting specific growth industries. More importantly, President Jokowi has pledged to spend more than USD400bn on infrastructure projects including ports, roads and railways. These efforts should help lift consumer spending with private consumption up 5.04% y/y in 2Q vs. 4.94% in 1Q. Growth is expected to rise above 5.0% to around 5.20% in 2016 and then to around 5.3% in 2017.
- However, there are some short-term upside risks to the USDIDR outlook. The slow start has taken some of the wind out of the tax amnesty law. To date, only IDR7.66tn has been repatriated under the

tax amnesty programme, significantly lower than the IDR560tn that BI has pencilled in. Though this is still early days, the slow start raises concerns that the targets set by the government might not be met and this could weigh on the IDR.

- Similarly, there are near term risks to growth prospects. Though Indonesia is one of the top performing economies in the region, weak external demand still continues to weigh. The President's 7% growth goal appears to be on the back burner for now. Recent suggestions by FinMin Sri Mulyani that even the growth target of 5.2% for 2016 could be hard to achieve in the current environment. The BI is expected to cut its policy rate by 25bp at its Sep meeting to bolster growth and that could be supportive of the USDIDR but this is likely to be temporary only before the boost to growth weighs on the pair.
- More importantly, the re-pricing of a Fed rate hike in 2016 in the week of 22 Aug, possibly the earliest in Sep, has led to a reversal in fund inflows particularly from government debt. Since 22 Aug, foreign funds have removed IDR7.2tn from their outstanding holding of government debt, though month-to-date funds inflow to government debt remains positive. Since the beginning of Aug, foreign funds have added IDR10.2tn of government debt to their outstanding holding. The still healthy inflows have helped to mitigate the recent outflows and have helped to prevent a large upmove in the USDIDR.
- Likewise, foreign investors have also sold off USD66mn of equities since 22 Aug in anticipation of the resumption of Fed rate hike in 2016. This reversal though does not even come close to offsetting the USD1.04bn that has flowed in so far in Aug. These inflows should continue as long as the infrastructure programme and economic reforms remain on track though in the near term there could be further outflows in response to a Fed fund rate hike. These inflows should be supportive of the IDR and cap any aggressive upmoves in the USDIDR.
- Taken together, these short term weaknesses could keep the USDIDR from dropping below the 13000-levels. As the Fed resumes its rate hike in Dec, further dollar strength could lift the USDIDR higher, though positive domestic factors could cap upside around 13300 by year-end. Going into 1H 2017, the positive factors, including the accelerated gains from the tax amnesty bill, should weigh on the USDIDR. We expect the pair to settle lower and hover around the 13200 levels in both 1Q and 2Q 2017.
- **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Indonesia improved slightly to 5.6 from 5.7 previously, due to the improvement in current account risk. This should supportive of the intrinsic value of the IDR.
- **Growth and Inflation Outlook:** Growth surprised on the upside in 2Q, coming in at 5.18% y/y after rising by just 4.91% in 1Q and beating market estimates of 5.0%. Private consumption rose by 5.04% y/y in 2Q compared to 4.94% in the previous quarter, helped by the cash transfers given to civil servants ahead of the Ramadan celebrations. As well, the initial 12 stimulus packages have helped to create a more business-friendly investment climate, bolstering the economy. Government spending rose by 6.28% in 2Q compared to the mere 2.93% posted in 1Q. However investment activities continue to lag with gross fixed capital formation growing by 5.06% y/y vs. 1Q's 5.57%. The government expects full-year growth to come in at 5.2% in 2016 and then 5.3% in 2017 but this might be difficult to achieve given the current global economic environment. Even Fin Min Sri

Mulyani has pointed this out in her testimonial to parliament. Our economic team expects full-year growth at 5.09% for 2016 on the back of the government's push for more infrastructure building, stronger investment and incentivized by government's offer of tax breaks to drive growth.

- Inflation remains benign, coming off its above 7% levels in mid-2015. Headline inflation rose by 3.21% y/y in Jul, the fourth consecutive month that headline inflation has come in below 4%. Food prices continued to come off, expanding by 6.81% y/y in Jul compared to 7.77% in Jun. Also, transport cost faces deflationary pressure still, falling by 1.49% y/y in Jun. Core inflation was steady in Jul, rising by 3.49% y/y. Inflationary expectations remain well-anchored, and recent strength in the IDR and government policies to slow the pace of prices increases (by giving subsidy for school fees) have continued to keep consumer price increases benign. Our economic team maintains its headline and core inflation at 3.53% and 3.48% in 2016 respectively, while BI continues to expect headline inflation to average 3-5% for 2016.
- **Monetary Policy Forecast:** BI kept its ammunition dry at its 21 Aug policy meeting as it officially completed the move to a new monetary policy framework. The 12-month BI reference rate was replaced by the 7-day reverse repo rate (7D-RR) and the interest rate corridor is now in effect. The 7D-RR was left unchanged at 5.25% but the interest rate corridor was narrowed with a cut to the overnight lending facility by 100bp to 6%. This was to maintain a symmetrical and narrow 75bps corridor on either side of the new policy rate. This decision by the BI to keep policy on hold was probably to prevent any policy-driven volatility and prevent confusion with the implementation of the new framework. That said, BI continues to see room for further easing ahead. Our economic team expects the policy rate to be cut at the next meeting on 22 Sep to provide additional support for the economy amid benign inflation and a stable IDR. The window for a rate cut is narrowing as a cut in Sep would allow the pass-through to the economy to be felt by 1H 2017.
- It was reported that BI is considering relaxing rules to allow banks to report their reserve-requirement ratios as monthly or weekly averages. Currently, banks have to submit these ratios on a daily basis. As well, BI is also mulling plans to allow foreign lenders and branches of foreign banks to sign syndicated loans and lend to non-oil and gas exports to ensure their targets for loans to SMEs are met.
- **Latest Fiscal and External Balance Outlook:** President Jokowi presented his proposed 2017 budget to parliament on 15 Aug. The proposed budget was billed as more realistic than the previous two he had presented, and was aimed at containing the fiscal deficit. The 2017 budget comes three weeks after the appointment of Sri Mulyani as the FinMin and is likely to have influenced the new budget proposal. The 2017 budget calls for spending of IDR2,070.5tn and revenue of IDR1,737.6tn with a deficit target of 2.41% of GDP, down from 2016's 2.5% of GDP.
- The Finance Ministry provided more clarity on the rule of the tax amnesty law with the issuance of a ministerial decree dated 23 Aug that directed tax amnesty participants to declare their assets owned indirectly through special purpose vehicles (SPV), both onshore and offshore. Participants have to transfer ownership of the assets in the SPVs to their own names or to an Indonesian entity. Compliance of this decree by end 2017 will ensure that the transferred ownership of land, building and shares in Indonesia be freed of income tax.

- The current account deficit (CAD) narrowed moderately to USD4.68bn in 2Q 2016 or 2.0% of GDP compared to USD4.76bn (2.2% of GDP) in 2Q. The narrower deficit was attributable to a larger goods and services surplus of USD1.7bn (1Q: USD1.6bn) and lower-than-expected deficit in the income account, which came in at USD6.4bn vs. 1Q's USD6.3bn. The overall balance of payments returned to a surplus of USD2.2bn in 2Q after slipping into a deficit of USD0.3bn in 1Q on the back of a wide surplus in the financial account, which more than offset the CAD. Meanwhile, our economic team now expects the 2016 CAD to come in at 2.2% of GDP instead of 2.45%, given the lower CAD in 1H 2016.
- **Key domestic events and issues to watch:** BI meets to decide on policy on 22 Sep.
- **Technical Outlook:** Weekly, daily momentum indicators suggest some upside risks in the interim. Pair was last seen at 13250 levels. Next resistance at 13370 (38.2% fibo retracement of 2016 high to low) before 13410 (200 DMA). Support at 13170 (21, 50 DMAs) before 13000 levels.

PHP: Playing Catch-Up Amid Return In Investor Confidence

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDPHP	46.00 (47.50)	46.50 (47.80)	46.70 (47.50)	46.90 (47.50)

Previous Forecasts in Parenthesis

- **Motivation for the FX View**: The PHP has been a laggard among its regional peers so far in 2016. While its peers have gained over 3.8% against the dollar so far this year, the PHP has only managed to rise by just 1.0% vs. the dollar. However, since the beginning of Aug, the PHP has been the best performer among the regional currencies, gaining around 1.5% against the dollar. Idiosyncratic factors have been the main driver of PHP gains in Aug, not least among them was the dissipation of domestic political uncertainty risks. However, these gains in the PHP have been mitigated partially by the market's re-pricing of a Fed rate hike in 2016.
- Even before the election of Rodrigo Duterte as president at the 9 May elections, market had been bracing for political uncertainty. This was uncertainty over who would succeed then-President Aquino as he was constitutionally barred from seeking a second term. Moreover, there were concerns that the series of reforms that earned the country an upgrade to investment grade from the three major credit rating agencies could stall with the new president. In addition, a cast of largely unknowns without a clear economic agenda at that time had increased fears that the region's economic speedboat could be put at risk. These doubts were put to rest with the peaceful transition to the Duterte administration and the continuation of business-friendly economic policies. This helped to spark a renewed interest in Philippine assets that has been supportive of the PHP.

- Despite the renewed investor confidence in Philippines, expectations of a Fed rate hike in 2016 - possible even in Sep - have led to some adjustment in the allocation of emerging market assets including those of the Philippines. Unlike in Jul, foreign investors have purchased just USD20.32mn in equities. This is a significant moderation from the USD418mn bought for the whole of Jul. Similarly, domestic and foreign demand for government debt appears to have fallen off in Aug, indicating some sell-off had taken place. Yields were higher by 6.56-104.30bp for most of the tenors across the yield curve but lower by 15.45-52.26bp for the 3M, 6M, 3Y and 4Y bonds.
- Economic fundamentals remain strong to date with the economy enjoying persistent balance of payments surpluses and outperformance in economic growth amid accommodative monetary policy. The accelerated government spending under former President Aquino that had led to strong economic growth in 1H 2016 (2Q GDP rose by 7% vs. 1Q's 6.8%) will be extended by the new Duterte administration. The Duterte administration intends to progressively increase infrastructure spending from 5% of GDP in 2016 until it hits 7% by the end of its six-year term in 2022. Accelerated spending has so far supported consumer spending with private consumption spending up by around 7% in 1H2016 so far compared to the 6% achieved in 2015. Continued robust domestic demand should allow the economy to expand by at least 7% in 2016. The healthy macroeconomic fundamentals should continue to provide the backstop to any rapid bounce in the USDPHP.
- In addition, recent relaxation of foreign exchange rules to residents to satisfy their demand for foreign currencies should create more two-way flows amid healthy foreign portfolio inflows so far this year. These measures (see table below) should relieve some of the domestic pressures for foreign currencies but is unlikely to completely mitigate upside pressures from foreign demand for Philippine assets. However, should upward pressure on the PHP continue, we could see these rules loosen even further.

Table 1: FX Rules Relaxation (effective 15 Sep 2016)

1. Cap lifted on the amount of FX that residents can buy from the banking system without supporting documentation for non-trade current account activities from USD120,000 to USD500,000 for individuals and USD1mn for corporates
2. Residents are allowed to deposit their FX purchases from banks into their Foreign Currency Deposit Unit accounts before outward remittance
3. Banks and their FX corporations are now allowed to sell FX for resident-to-resident transactions
4. Prior BSP approval and registration requirements no longer required for the private sector to obtain FX loans
5. Non-banks with quasi-banking functions such as insurance companies, investment houses and trust companies can borrow from abroad without needing to seek BSP approval

Source: BSP, Maybank FX Research

- External factors continue to challenge the USDPHP. Despite healthy fundamentals, the USDPHP remains highly susceptible to risk events externally. These include the re-pricing of a Fed fund rate hike in 2016, the US presidential election in Nov and Brexit. The USDPHP faces risks from the US Fed resuming its fund rate hike this year, most likely in Dec. A Sep move though cannot be ruled out for now but we place a low probability of such an occurrence. Increasing expectations of a Fed move this year could keep the pair elevated towards the year-end and into 2017. As well, the uncertainty in the lead-up to the US presidential election could pose upside risk to the USDPHP. Concerns about a "President Trump", particularly his lower commitment to the security pact with Manila and to trade relations, could increase market volatility and spark safe-haven outflows from riskier Philippine assets. Concerns about Brexit also remain and re-emergence of these concerns could also see the move to safer-havens. These risks could keep the pair elevated going into 2017.

- Though risks of Fed fund rate hike this year has risen, the dissipation of domestic political and policy risks, together with the planned infrastructure spending, should encourage continued portfolio inflows to the Philippines, and weigh on the USDPHP. This should keep the pair from climbing higher too rapidly. We now expect the USDPHP to end 3Q at 46.00 (from 47.50 previously) but should rebound less aggressively to 46.50 (from 47.80) by end-4Q even as the US Fed resume their rate hikes in Dec. Thereafter, the pair should continue its climb higher in anticipation of further rate hikes in 2017, ending 1H17 near the 47-levels at 46.90.

- Our monthly **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, improved from 4.8 to 4.7. This was due to improvement in fiscal risk that more than offset the deterioration in current account risk. This should be supportive of the intrinsic value of the PHP.

- **Growth and Inflation Outlook**: Economic growth continues to outperform its regional peers, even China. GDP rose by 7.0% y/y in 2Q16 – the fastest pace in Asia – from 6.8% in 1Q. Domestic demand remained the engine of growth amid the drag from external demand. Domestic demand rose by 12.3% y/y in 2Q (1Q: 12.0%), bolstered by election spending and benign inflation that has lifted purchasing power. Private consumption expanded by 7.3% y/y, bringing 1H16 growth to 7.2%, while investment continued to tick higher by 27.2% y/y in 2Q. For 1H 2016, growth was at 6.9% and this puts the economy on track to achieve the 7% growth for the whole of 2016 that our economic team has pencilled in.

- To bolster growth towards the official target of 6.5-7.5% in 2017, the Duterte administration will lift the budget deficit to 3% of GDP from 2% under the previous administration. This is to accommodate the expected boost in infrastructure spending to 7% of GDP by the end of President Duterte's term in 2022. For 2017, the government is planning to spend about PHP900b (or 5.2% of GDP) on hard infrastructure, out of the planned PHP3.35tn budget for 2017. This accelerated spending should boost both domestic consumption as well as investment spending, and mitigate any slowdown in remittances as a result of slower growth in the G3 and oil-producing Middle Eastern economies.

- Headline inflation remained steady at 1.9% y/y in Jul – rising at the same pace as in Jun, helped by the moderation in food prices (Jul: 2.7% y/y vs. Jun: 2.9%) that offset the more moderate decline in housing cost (Jul: -0.2% y/y vs. Jun: -0.4%). Inflation has averaged 1.4% in the first seven months of the year. Much of this underperformance in inflation is due to oil prices. The stabilization in global oil prices should lift inflationary pressures. Even the risks of El Nino and election spending are unlikely to lift inflation significantly higher. For now, the central bank expects headline inflation to come in around 2.0% in 2016 and then rise to 3.1% and 2.6% in 2017 and 2018 respectively. Our economic team continues to expect headline inflation to average 2% in 2016 based on sustained low fuel prices and modest impact from El Nino.

- **Monetary Policy Forecast:** We continue to expect the BSP to stay on course and keep its policy rate steady at its next policy meeting on 22 Sep and for the rest of the year. This is barring a deterioration in the global economy. Moreover, the new interest rate corridor (IRC) framework that has been in place since 3 Jun allows for the more effective transmission of the policy rate to market rates. The overnight borrowing rate is currently at 3.0% (the policy rate) and the upper (overnight lending rate) and lower (overnight deposit rate) bands of the corridor at 3.5% and 2.5% respectively. Instead of adjusting the policy rate, the BSP is likely to focus relaxing macro-prudential tools to provide the economy with an extra boost.
- Rumors continue to swirl is that a RRR cut could be in the cards following comments by the central bank governor which suggested that he might reduce the amount of cash banks must set aside. The RRR is currently at 20% with the last adjustment in the RRR coming more than two years ago on 8 May 2014. A cut in the would release liquidity into the financial system, spurring yields and hence borrowing cost lower, and be supportive of domestic growth. Using macro-prudential measures to spur credit growth and support the economy would allow the central bank to save its ammunition for black swan events like Brexit.
- **Latest Fiscal and External Balance Outlook:** The budget deficit widened in Jul to PHP50.67bn from Jun's PHP45.19bn deficit as spending continues to outstrip revenue. The deficit position underpins the government's move to incur a larger budget deficit of 3% of GDP via accelerated spending to boost growth. In the first seven months of the year, the deficit amounted to PHP170.98bn compared to PHP121.69 for the whole of 2015.
- The overall balance of payments (BoP) surplus narrowed to USD215mn in Jul, only half of Jun's surplus of USD418mn. This though was the fifth straight month of BoP surplus. According to the BSP deputy governor, the increase was due to strong structural inflows, central bank's income from offshore investments, foreign exchange operations and net USD deposits from the national government. These inflows helped to offset the outflows from the state's debt payments in the month. With the cumulative surplus at USD848mn in the first seven months of the year, the BoP is on track to achieve the BSP target of USD2bn surplus for the whole of 2016.
- **Key domestic events and issues to watch:** The BSP will meet on 22 Sep to decide on monetary policy.
- **Technical Outlook:** Underlying trend (as indicated by monthly, weekly technical) suggests a mild bearish bias but daily technical suggests some upside risks in the interim. Next resistance at 46.72 levels (38.2% fibo retracement of 2016 high to low) before 47 levels (50% fibo, 200 DMA). Support at 46.20 (interim low in Aug) before 45.90 (2016 low).

THB: Resilient

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USDTHB	34.50 (36.50)	34.70 (37.00)	35.00 (37.00)	35.20 (37.20)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The USDTHB has been on the downtrend for most of Aug due to portfolio inflows searching for higher returns. Even the re-pricing of Fed rate hike expectations did not stem inflows into Thai assets. This has allowed the THB to rise by 0.5% against the dollar in Aug, the second best performer in the region after the PHP. Since the comments by both Fed Chair Yellen and Vice-Chair Fischer that triggered a Fed rate hike re-pricing, the THB is no longer lagging its regional peers. Instead, its resiliency has allowed it to be the second best performer in the region after the MYR. The THB has risen by 4.0% against the greenback so far this year.
- The resiliency in the THB can be partially attributed to the healthy domestic macroeconomic environment. A combination of accommodative monetary policy and expansionary fiscal policy has helped the Thai economy to rebound from its subpar growth performance in 2015 to around 3% in 1H16. Going forward, the boost to the economy is likely to come from the planned THB1.8tn infrastructure programme embarked by the government. The planned accelerated government spending and infrastructure programme should help to lift consumer spending. This in turn should provide the economy with another leg up amid weaknesses in exports. We are already seeing stronger private consumption spending in 2Q16 of 3.8% compared to 2.3% in 1Q. The lift from government spending, infrastructure expenditure and consumer spending could push growth higher to as much as 4.0% in 2016 and 5.0% in 2017.
- Aside from expansionary fiscal policy, monetary policy is expected to remain accommodative as well though no further rate cuts are envisioned for the rest of the year, barring unforeseen risks to the economy. Rate cuts would not solve the kingdom's export woes, while the policy rate is already at near historical lows and is unlikely to be effective in spurring further lending or investment activities. In addition, the central bank believes that fiscal policy should take the lead in bolstering the economy, while accommodative monetary policy should play a complementary and supportive role. Just as importantly, the central bank would like to keep its ammunition dry for even more adverse shocks to the economy like a disorderly Brexit or China hard landing (all not our base case).
- Like the Philippines, investors have been bracing for political uncertainty in the lead up to the referendum on the draft constitution on 7 Aug. There were concerns that the defeat of the draft constitution at the referendum would embolden the opposition, risk raising political temperature and delay the return to civilian rule, which has been planned for end-2017. However, the passage of the draft constitution put paid to those concerns. Investor confidence was

bolstered as a result and the relative calm in the political arena triggered a re-rating of risks, supporting the inflow of foreign funds.

- However, the political situation could very easily stage a turnaround especially on continued attempts at making changes to the draft constitution to increase the power and influence of the military. The more recent attempt to allow for the military-appointed senators to nominate the PM was rejected by the Constitution Drafting Committee. That power remains reserved for elected senators. Further tinkering with the draft constitution to enhance the power of the military at the expense of elected members could raise tensions and reignite political uncertainty, putting downside risks to the THB.
- Despite the rich valuation, Thai assets continue to attract the attention of foreign funds because of its political calm and infrastructure spending programme. Even the re-pricing of Fed rate hike expectations did not deter portfolio inflows into Thailand. In Aug so far, Thai equities and government debt have attracted THB32.72bn and THB62.73bn of foreign funds respectively compared to THB434.37bn and THB10.57bn in Jul. Year-to-date, foreign investors have purchased THB113.61bn and THB367.37bn in equities and government debt compared to the sell off of THB15.43bn and THB23.97bn for the whole of 2015. Continued inflows into Thai assets remain supportive of the THB.
- External challenges are likely to impact the USDTHB, particularly the US Fed's resumption of its rate hikes, the US presidential election, and post-Brexit developments. The risk from a US Fed fund rate hike this year, most likely in Dec, could put upside pressure on the USDTHB as funds reallocate their portfolio away from Thailand back to the US. We could see similar consequences in the lead up to the US presidential election. The US presidential election could pose upside risk to the USDTHB as a "President Trump" could increase market volatility and uncertainty, resulting in safe-havens flows and sparking another round of outflows from riskier Thai assets. In addition, Brexit concerns could spark another round of risk haven flows. Altogether, these risks are THB-negative.
- In sum, the passage of the draft constitution on 7 Aug, setting the kingdom on the path to an election and back to civilian rule, has spurred further foreign interest in Thai assets. The healthy inflows on the back of risk-supported sentiment has lifted the THB and makes it unlikely that USDTHB would move back above the 36-levels anytime soon, barring black swan events. We expect the USDTHB to hover around the 34.50 levels by the end of 3Q before edging higher to 34.70 by end-2016 on the possible US Fed rate hike in Dec. Expectations of further rate hikes in 2017 should keep the pair elevated in 2017 with the pair ending 2017 at 35.20.
- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Thailand deteriorated to 4.2 from 3.9 in the previous month due to the deterioration in the current account and fiscal risks. This should weigh on the intrinsic value of the THB.
- **Growth and Inflation Outlook:** The economy continued to show improvement, expanding by 3.5% y/y in 2Q16 from 3.2% in 1Q. Growth was largely driven by an improvement in private consumption, which rose 3.8% y/y in 2Q vs. 2.3.% in 1Q. However, government spending moderated in 2Q, rising by just 2.2% y/y as compared to 8.0% in 1Q. Public investment spending though remained relatively resilient, up 10.4% y/y in 2Q vs. 13.3% in 1Q. Growth in 1H16 rose by 3.4% y/y.

Beyond 2Q, growth is expected to accelerate in 2H on the back of infrastructure project spending. Projects worth almost THB200bn will be open for bidding in 2H and this should boost construction and lift fund disbursement ahead. The recent multiple bombings in the south of Thailand are not expected to adversely impact tourism, which makes up 10% of GDP, as other tourist destinations within Thailand should continue to attract foreign visitors. The BoT continues to expect the economy to expand by 3.1% and 3.2% in 2016 and 2017 respectively. Our economic team though is more optimistic about the impact of infrastructure spending on the economy and expects real GDP to come in at above-consensus 4.0% this year before accelerating to 5.0% in 2017.

- Headline inflation remained in positive territory for the fourth straight month but is back on the deceleration. Headline inflation rose by 0.1% y/y in Jul compared to 0.38% in Jun, weighed still by softer food prices, which moderated to 1.83% y/y in Jul vs. 2.8% in Jun. Higher energy prices has resulted in transport cost ticking slightly higher but overall cost remained in negative territory (Jul: -2.03% vs. Jun: -2.37%). These together with weak housing costs have capped inflationary pressures. Despite the weak inflationary print for now with headline inflation averaged 0.1% in the first seven months of the year and is forecasted to come in at 0.6% in 2016, the BoT expects inflation to return to 1-4% in early 2017, according to BoT governor Veerathai. Our economic team is even more bullish, expecting low base effects, improving domestic demand, the impact of the drought on raw food prices, the firmer oil prices and the weak THB to lift headline inflation to 2.0% on average in 2016.

- **Monetary Policy Forecast:** The BoT has not adjusted its key rate since 29 Apr 2015 with the policy rate held steady at 1.50%. The last time the policy rate was lowered was during the Great Financial Crisis in 2009-10. With the rate already at near historical lows, there is little need for the BoT to adjust the policy rate for now. Going forward, we expect the central bank to remain on hold for the rest of the year. Note though that this does not preclude the central bank from adjusting its policy rate if the situation calls for it. For now though, the BoT believes that fiscal policy should do the heavy lifting in boosting growth, with monetary policy playing a complementary and supporting role. Moreover, the concomitant weakness in the THB from a rate cut is unlikely to be a panacea for the kingdom's export woes. As well, pausing on policy would allow the central bank to keep its ammunition dry for black swan events.

- **Latest Fiscal and External Balance Outlook:** The government is expected to finance the budget deficit and infrastructure projects by issuing debt. It plans to borrow THB614bn in fiscal 2017 mainly from the domestic market where liquidity remains ample. Of the THB614bn borrowed, THB390bn will be allocated to meet budget deficit needs and the rest will be for infrastructure investment. The proposed funding plan will be submitted to the cabinet at the end of Aug.

- The current account surplus widened to THB128.63bn in Jul from THB105.12bn in Jun – the second straight month that the surplus has widened. The wider surplus was largely to the surplus in the primary and secondary income account of THB16.57bn in Jul compared to –THB28.73bn in Jun that reinforced the trade surplus of THB493.96bn. The overall balance of payments (BoP) surplus however shrank in Jul to THB0.40bn in Jul vs. Jun's THB65.65bn.

- **Key domestic events and issues to watch:** BoT will decide on its rate decision on 14 Sep.

- **Technical Outlook:** USDTHB continued to drift lower in Aug. Last seen at 34.55 levels. Weekly momentum is showing mild bearish bias. Next support at 34.50 levels (50% fibo of 2015 low to high) before 33.98 (61.8% fibo). Resistance at 34.80 (upper bound of trend channel), 35.00 (38.2% fibo), 35.40 (200 DMA).

INR: Resilience

Forecast	3Q 2016	4Q 2016	1Q 2017	2Q 2017
USD/INR	67.00 (65.00)	68.00 (66.00)	69.00 (67.00)	69.00 (67.00)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Modi has been making good progress which leads us to question why the USDINR is still above the 67-figure. Apart from getting the GST bill to be approved by both the Rajya Sabha and Lok Sabha, PM Modi and Finance Minister Jaitley seem to have made the excellent choice of replacing Rajan with current Deputy Governor Urjit Patel who is one of the very few hawks in the names that have come up before the appointment. In a sense, promoting Urjit Patel signifies that the government desires continuity of the good work that Rajan has done without his huge "Rockstar" persona and loud critics of the government. That includes clearing the banks' balance sheet (by Mar 2017) and making sure that the new reforms on the FX and fixed income market that is just announced by Rajan gets implemented. Urjit Patel is also likely to keep the balance between achieving growth and inflation management.

- There are still plenty to be done for GST to be rolled out next Apr (2017). Apart from getting at least 15 states (out of 29) to ratify the bill, the GST Council will be formed with representation from the central government as well as all the state governments. The Council will also be making recommendation including exemptions, thresholds, actual GST rates (revenue netural) amongst others. Near-term impacts of GST are likely sharp, albeit transient, rise in prices next year. Medium term impacts are still uncertain even though there has been much optimism about it simplifying the tax system to avoid double taxation, spurring better supply mobility across inter-state borders that could eventually boost India's GDP level by 1-2%.

- We are looking for USDINR to remain rather steady for the rest of the year. Upside risks stem from dollar strength as markets start to reprice a Sep rate hike. We anticipate a hawkish hold in Sep which should see a shallow correction in USD and modest upside risks in USDINR for the rest of the year. Upmoves are unlikely to be drastic. We are more wary of the USD20bn outflows (from the FCNFR (B) redemptions) that the RBI has estimated to happen in the next four months but we are also comforted by the fact that the central bank has probably amassed a substantial of USD363bn of FX reserves as of Jun.

- **Our Maybank vulnerability score (using 9 economic and market variables:** GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for India improved to 4.3 (with 1 being the best score and 9 being the worst) from previous 4.6

due to a improvement in its score for current account, fiscal accounts relative to its peers.

- **Growth and Inflation Outlook:** Industrial production rebounded to 2.1% in Jun from previous -1.1%, underpinned by stronger growth in mining, manufacturing and electricity output. We expect momentum to sustain into Jul as hinted by the PMI-mfg for Jul which rose to 51.8 from 51.7, The Markit report cited strong growth in new orders and production. While output growth for Jun is likely to its strongest in the past four months, the survey also highlighted that job creation was still flat, suggesting that the slack in the labor force has not tighten much. The RBI industrial outlook survey for 2016-2017 shows improvement in demand condition in the first quarter of 2016-2017 compared to a the same period a year ago. Net percentage responses indicate higher production, order books, exports/imports and employment during the quarter went up. The business sentiment of the manufacturing sector was deemed more upbeat than the quarter prior. Firms responded positively on most metrics with the exception of cost of finance and cost of raw material.
- Monsoon forecast has thus far been pretty optimistic but the India Meteorological Department has told the press that monsoon forecast could be reviewed. This comes after the monsoon rainfall fell to 3% below normal as of 28 Aug. Further deterioration may threaten agriculture output as the forecasted above-normal rainfall level is estimated to boost farm growth to 6% this year and add 40bps to growth according to our India analyst. Rural productivity, farm income and rural demand could see a rise amid benign inflation trajectory. Household consumption will continue to be a pillar of support as the government and central bank strive to crowd in private investment with reform measures.
- Food inflation keep headline CPI elevated at 6.07%y/y for Jul, a accelerating from Jun's 5.77%. Wholesale prices also jumped to 3.55%y/y from previous 1.62% and we look for this print to remain elevated after the government raised kerosene prices in Jul. In addition, a pay hike for central government employees that would be implemented within the financial year 2016-2017 would also fan demand-led price pressures.
- **Monetary Policy Forecast:** The Reserve Bank of India will make its next rate decision on 4th Oct. We continued to anticipate an extended pause by the central bank as current monsoon seems to have turned a little less than what the India Meteorological Department has projected. With persistent upside surprise for a number of inflation print, a recent kerosene price hike and a recent pay hike for central government employees, Urjit Patel is unlikely to allow a rate hike at his first rate decision meeting. We await the formation of the MPC.
- **Latest Fiscal and External Balance Outlook:** Foreign investors bought USD1.12bn of equities and sold USD300.5mn of bonds in Aug as of 25 Aug. Sentiments have been buoyed by a number positive news at home while the lower probability of a rate cut weighed on domestic bonds.
- India's fiscal targets were held steady at 3.5% for FY16/17. The government highlighted "Transform India" that is meant to boost domestic demand, continue the pace of economic reforms and policy initiatives. There was also focus and budget allocation for agriculture and farmers' welfare - Irrigation projects will be sped up, a dedicated Long Term Irrigation Fund will be created as well as programme for sustainable management of ground water resources. There is also a substantial amount allocated to education and health care, as well as

infrastructure and investment. Total expenditure projected to be INR19780bn – INR14280bn of which is non-plan and INR5500bn is plan. The plan and non-plan classification will be scrapped in the next fiscal year. The plans outlined should work to improve inflation expectations via the supply side measures whilst boosting rural demand.

- As of last release, the current account deficit narrowed to just $0.3bn in the quarter ending Mar from the previous $7.7b due to the better performance of net exports of goods (-U$34.0bn vs previous U$37.4bn) and greater net current account services surplus at USD18bn. Current account deficit may deteriorate in 2Q as we witnessed a stronger improvement in imports that surpassed that of exports, causing the trade deficit to widen considerably in Jun. That said, its balance of payments position is likely to be buffered by steady equity inflows seen in the past three months.
- **Key domestic events and issues to watch:** India has 2Q GDP due on 31^{st} Aug followed by Aug PMI-mfg on the 1^{st}. Aug trade is due anytime within 9^{th}-15^{th}. Aug CPI and Jul industrial production are due on the 12^{th}, WPI on 14^{th}.
- **Technical Outlook:** USDINR has been stuck within the narrow range of 66.50-67.50. Momentum indicators are not showing much directional bias on the daily chart but monthly chart shows more potential for downside. That may come slowly. We see two-way risks for this pair in the interim and a breakout to expose the next support at 64.86. Barrier at 68.80.

VND: Ebbing Support

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

No Change from Previous Forecast

- **Motivation for the FX View:** USDVND has been edging higher in the past week, last seen around 22310. As we have mentioned, the pair is vulnerable to USD strength. VND has been mainly underpinned by strong FDI inflows and trade surplus. The support of the FDI inflow could be ebbing but that of the trade surplus seem to be still intact, as indicated by stronger PMI-mfg numbers, sustained growth of exports growth. Trade balance has been tilting into positive, last seen at U$200mn. For Sep, we anticipate USDVND to gain upside momentum along with most of USDAsians but a hawkish hold could see some correction that should guide the USDVND to around 22400. Towards the end of the year, we see USDVND at 22600, guided by broad USD strength. Our forecast assumes Japan fires enough monetary and fiscal stimulus to keep USDJPY largely within 100-110 for the rest of the year.

- Economic-wise, Vietnam has seen some challenges with its fishery and agriculture industry after the Formosa Vietnam Discharge killed more than 240MT of Fish. PM Thanh has ensured that the whole disaster was thoroughly investigated. Formosa is held to a U$500mn compensation and PM Thanh assures that the fund that is meant to improve offshore fishing and environmental protection will be transparent. This was done to regain investors' confidence in the country. Still, the supply-side disruption will weigh on growth. The drought has also crimped on the agriculture sector, causing a contraction of -1.1%y/y in 2Q. We expect some upside pressure on food costs into 2H. In fact, Head of National Assembly Economic Committee Vu Hong Thanh said that the 6.7% growth target for 2016 is "hard to reach" and that it is "not possible to loosen monetary and fiscal policies in the last 6 months (of the year)". That said, the Ministry of Finance has proposed a tax cut for SMEs to 17% which would take effect from 2017-2020. The state budget revenue would see a decrease of VND473bn from CIT should tax revision apply to firms with revenue under VND20bn.

- Medium term, Vietnam's apparel, footwear, agro-forestry and seafood industry were meant to get the boost from the Trans Pacific Partnership. However, we are still cautious of the fate of the seafood industry after the recent disaster especially as PM Thanh has planned for fishermen to find new employment. **Key risk to the medium term view is a surprise Donald Trump win at the Presidential Elections that may jeopardize the Trans Pacific Partnership and reverse the FDI flows that have benefitted Vietnam thus far this year.**

- **Growth and Inflation Outlook:** PMI-mfg slipped only a tad to 51.9 from previous 52.6. Markit reported weaker growth in new orders, output and employment. However, new businesses and new export orders continued to rise. Manufacturing is a bright spot for the economy and rising new export orders suggest sustained external demand. Exports growth accelerated to 5.5%y/y in Jan-Aug compared to Jan-Jul. Private consumption seems to be holding up as its proxy, retail sales for Jan-Aug slowed only a tad to 9.3%y/y from 9.4% for the first 7 months of the year. Vietnam has to count on its manufacturing and services sector for growth for the rest of the year.

- Inflation came in at 2.57%y/y for Aug, firming from the previous 2.39%. The rise in CPI seen in 2Q was due largely to higher housing and construction. We continue to expect inflation to remain on a gradual upward trend given supply side impact on agriculture and fishery.

- **Monetary Policy Forecast:** SBV has not moved policy rates for a while and we think the central bank could still find room to ease given inflation trajectory remains rather benign. With the growth target seemingly out of reach, SBV might need to ease rates (currently base rate at 9.0%, refinancing rate at 6.5% and discount rate at 4.5%) in order to nudge the growth engine a little by boosting domestic spending. That would take its credit growth above its annual target of 18-20%. FX-wise, the central bank has not been tweaking the USDVND reference rate much day-to-day despite broad yuan weakness. With exports growth decelerating and lean FX reserves-import ratio of around 2, any external shocks in the FX space could force SBV to devalue the dong. Should USD remain on the upmove, expect USDVND reference rate to be fixed higher and that should guide the USDVND towards our 22400 forecast by 3Q.

- **Latest Fiscal and External Balance Outlook:** Vietnam is running out of fiscal room to boost growth. The Ministry of Finance revised the fiscal deficit significantly higher to 6.6% of GDP in 2014 and 6.1% for 2015. We see upside risk as MOF has just proposed to lower existing tax rates for SMEs from 20% to 17% so as to encourage companies to engage in productive investment.

- We still watch the Japanese yen as Vietnam's external debt/GDP stood at 41.5% as of end 2015. Strong relationship with Japan suggests that JPY-denominated debt could be at least 30% of total debt (as reported by our Vietnamese analysts) and a stronger JPY could weaken Vietnam's debt position. That said, given the threat of BOJ intervention and potential monetary and fiscal stimulus, we expect USDJPY to remain within 100-110 for the rest of this year. That should in turn alleviate pressure on Vietnam's debt.

- Growth of exports remains positive for the past eight months at around 5.5%y/y and PMI-mfg for Aug signal strong new export orders. Current account recorded a surplus of USD2.63bn in 1Q (latest data available), an improvement from U$1.08bn in 4Q on the back of larger exports of goods and lower decline in net services. Strong FDI and potential improvement on the external front could keep the VND stable.

- **Key Domestic Events and Issues to Watch:** PMI-mfg is due on the 1st. CPI is due on the 24th. Trade balance, retail sales, industrial production and **3Q GDP** will be released anytime within 25-31st.

FX Forecasts

	End Q3-16 f	End Q4-16 f	End Q1-17 f	End Q2-17 f
USD/JPY	110	112	112	114
EUR/USD	1.1100	1.1000	1.0800	1.1000
GBP/USD	1.2500	1.3000	1.3000	1.3500
AUD/USD	0.7400	0.7600	0.7500	0.7600
NZD/USD	0.7000	0.7000	0.6900	0.7200
USD/SGD	1.3650	1.3750	1.3800	1.3850
USD/MYR	4.0000	4.0000	3.9500	3.9500
USD/IDR	13200	13300	13200	13200
USD/THB	34.50	34.70	35.00	35.20
USD/PHP	46.00	46.50	46.70	46.90
USD/CNY	6.65	6.67	6.70	6.70
USD/HKD	7.80	7.80	7.80	7.80
USD/TWD	32.40	32.40	32.80	32.80
USD/KRW	1125	1170	1180	1180
USD/INR	67.00	68.00	69.00	69.00
USD/VND	22400	22600	22700	22800
SGD Crosses	**End 3Q-16**	**End 4Q-16**	**End 1Q -17**	**End Q2-17**
100 JPY/SGD	1.2409	1.2277	1.2321	1.2149
EUR/SGD	1.5152	1.5125	1.4904	1.5235
GBP/SGD	1.7063	1.7875	1.7940	1.7728
AUD/SGD	1.0101	1.0450	1.0350	1.0526
NZD/SGD	0.9555	0.9625	0.9522	0.9972
SGD/MYR	2.9304	2.9091	2.8623	2.8520
SGD/IDR	9670	9673	9565	9531
SGD/THB	25.27	25.24	25.36	25.42
SGD/PHP	33.70	33.82	33.84	33.86
SGD/CNY	4.87	4.85	4.86	4.84
SGD/HKD	5.71	5.67	5.65	5.63
SGD/TWD	23.74	23.56	23.77	23.68
SGD/KRW	824.18	850.91	855.07	851.99
SGD/INR	49.08	49.45	50.00	49.82
MYR Crosses	**End Q3-16 f**	**End Q4-16 f**	**End Q1-17 f**	**End Q2-17 f**
EUR/MYR	4.44	4.40	4.27	4.35
JPY/MYR	3.64	3.57	3.53	3.46
MYR/HKD	1.95	1.95	1.97	1.97
MYR/CNY	1.66	1.67	1.70	1.70
GBP/MYR	5.00	5.20	5.14	5.06
AUD/MYR	2.96	3.04	2.96	3.00
NZD/MYR	2.80	2.80	2.73	2.84
MYR/IDR	3300	3325	3342	3342
MYR/INR	16.75	17.00	17.47	17.00
MYR/KRW	281	293	299	299
MYR/PHP	11.50	11.63	11.82	11.59

Source: Maybank FX Research as at 31 August 2016

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

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