Aug 30, 2019

Maybank

FX Monthly

2019, Issue 8: Feud or Feint?

What Has Changed This Month?

- We revised USD forecast broadly higher vs. most AXJ currencies, taking into consideration the recent escalation in trade tensions between US and China.

Our Strategies

- Our caution for a seasonally bearish month of Aug played out well as most USDAXJs rose along with AUDNZD (RBA-RBNZ monetary policy divergence) idea. Our tactical call for INR and IDR to come under pressure and THB to outperform also materialized. Going into the month of Sep, we expect bearish seasonality to fade. Technically signs of bearish divergence could be forming on USDKRW, USDCNH. We do not rule out USDKRW and USDCNH testing lower towards 1185, 7.10 levels, respectively.

- Our observation for the USDCNY fix and recent comments on "removing tariffs" by China's MOFCOM spokesperson Gao suggests that positive development coming out of the ongoing trade discussions with the US should not be ruled out. With markets still cautious and sceptical of recent quick de-escalation (coming from Trump), any chance of good news (delayed tariffs) probably not priced now, could help USD/AXJs lower eventually. We also see some risks of profit-taking in recent gains in gold prices. As such, strength in gold-linked THB could fade. We suggest longs in USDTHB.

- The latest Trump tariff announcement and latest China retaliation could worsen global sentiment and growth concerns may emerge, and as such raise likelihood of a Fed cut in Sep and in the last few months this year. Our economics team is looking at a baseline of 100bps (including 25bps cut already delivered) up to 1H 2020.

- We expect limited degree of precautionary easing from ECB which include 10bps cut to current deposit rate of -0.40% and re-introduction of TLTRO-III as planned with rate at par to MRO. We stopped short of calling an all-out easing (i.e. deeper cut to deposit rates and QE) in part to avoid expending its monetary policy tools too soon and in part due to limitations on how effective further rate cuts may be on the economy when key policy rates are already negative.

- Though UK is not out of the brexit uncertainty and suspension of parliament reinforced a no-deal brexit as a base case scenario for most (unlike in previous periods when the base case was soft brexit), we argue that any potential and incremental signs of good progress (either a modified deal or even a delay) coming out of discussions with EU may well provide the much-needed catalyst for the move higher in GBP, especially when GBP short positions is stretched (nearly 30-month high). Bias to accumulate GBP on dips.

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Top 3 Currency Plays for Sep

Tactical short USDCNH, USDKRW

Long USDTHB

Accumulate GBP on Dips

Key Events for the Month Ahead

Date	Event
1 Sep	Tariff Effective for US and China
Early Sep	Cabinet reshuffling for Italy alternative coalition government
20 - 21 Sep	Deadline for UK PM to provide an alternative backstop solution
27 Sep	FTSE Russell's decision on Malaysia bonds in WGBI

SEE PAGE 56 FOR IMPORTANT DISCLOSURES.

G7 Global Overview

USD: Fed Poised to Ease

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USD Index	98.42 (98.67)	97.62 (97.87)	97.17 (--)	96.69 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The last Aug FOMC statement was not unanimous, it was also non-committal to a further rate cut and any future ones will be data dependent, Chairman Powell's relatively hawkish response during the Aug press conference and the Fed will end its balance sheet rundown in August, two months earlier than previously planned. All the above, initially pointed to a high likelihood of a pause in the Sep FOMC and paves the way for expectations that the Fed will stay on pause, with upside to the USD and 10 year yields over the next few months at least.

- Fed Chair Powell's speech at Jackson Hole was being interpreted as Fed being more open-ended and flexible with regards to policy as he dropped reference to mid-cycle adjustment to policy. This gave the impression that the Fed may well be closer to further easing than before. Subsequently re-escalation of trade tensions between US and China stole the headlines lately. China announced additional levy of 5 – 10% on $75bn of US goods, including an additional 25% on US autos and 5% tariff on US crude oil imports while Trump retaliated by increasing tariff rate to 30% (from 25%) on the $250bn worth on Chinese imports and to 15% (from 10%) on the remaining $300bn of Chinese imports. DXY was softer owing to the rise in JPY, EUR and to some extent, even the GBP. Against AXJs, USD rose.

- The latest Trump tariff announcement and latest China retaliation could worsen global sentiment and growth concerns may emerge, and as such raise likelihood of a Fed cut in Sep and in the last few months this year. Our economics team is looking at a baseline of 100bps (including 25bps cut already delivered) up to 1H 2020 and it looks unlikely that the Fed will cut rates close to the US Presidential election amid moderating growth. The market is pricing in 81/117bps cut next 6 months/2 years.

- Into the end of the year, our base grey-swan scenario is still that of a protracted period of negotiation with "lines of communication" remaining open. Progression on talks taking both sides closer to a deal probably in 1H 2020 is not impossible and this could help support sentiment and support our view for trade/tech-linked FX to recover. A reversion back to risk-on mood at times, low vol environment amid central banks on easy monetary policies could still see carry plays outperform at the expense of lower yielders such as JPY.

- **Growth and Inflation Outlook:** The second print of U.S. 2Q GDP results showed a mild downward revision to overall growth, 2.0% versus the initial 2.1% advance report. But he underlying fundamentals signal a more resilient economy heading into the second half of the year (ahead of increased international trade headwinds). Consumer spending, at the moment was even stronger than first reported, and corporate profits bounced back from a two-quarter slide. Business investment remained weak, but corporate-profit growth seems to be appropriate to support a recovery once economic sentiment improves, or at least stabilizes. There is strong likelihood though that growth will fall below 2% in 2H 2019 due to heightened uncertainty amid trade tensions.

- Core CPI firmed up Firming core CPI in July is challenging the Fed's view that a return to its 2% inflation target would take longer than previously projected. After two consecutive increases of 0.3% -- unprecedented in this business cycle -- the 2.2% year-over-year pace is just a tenth of a percentage point lower than the level consistent with the Fed's preferred inflation gauge, the core PCE deflator, rising toward 2.0%. Core CPI may hit the 2.3% pace as early as August, even if the monthly pace decelerates to 0.2%.

- The July data may raise concerns among more hawkish policy makers on the prospects of further monetary policy easing, especially following the newly announced delay in some U.S. tariffs on Chinese goods.

- The core consumer price index, which excludes food and energy, rose 0.3% from the prior month, and 2.2% from a year earlier. Both gains exceeded the median estimate of economists, while the broader CPI advanced 0.3% on the month and 1.8% annually.

- Faster inflation may strengthen the hand of Fed members who are reluctant to keep lowering borrowing costs following last month's quarter-point reduction, as employment and consumer spending remain solid. At the same time, the latest ratcheting-up of U.S.-China trade tensions and a deepening global economic slowdown are weighing on the outlook, with investors pricing in two to three more moves this year. Following the report, traders trimmed slightly the amount of Fed easing they have priced in for this year while the 10-year Treasury yield climbed to its high for the day. Those moves were amplified later in the morning, and stocks surged, after the U.S. delayed tariffs on a range of consumer goods from China by more than three months, to Dec. 15.

- A separate Labor Department report showed average hourly earnings, adjusted for price changes, rose 1.3% in July from a year earlier, following 1.5% in June, indicating higher inflation took a bigger bite out of wage gains.

- **Monetary Policy Forecast:** The FOMC cut its policy Fed Funds Target Rate (FFTR) by 25bps to the 2-2.25% range in its latest 31 Jul meeting, but it was not a unanimous decision (8-2) as Boston Fed President, Eric Rosengren and Kansas Fed President, Esther George wanted to keep rates unchanged. The Fed also announced an earlier termination of its

Balance Sheet Reduction (BSR) program in Aug 2019 (from Oct 2019 previously).

- The Jul Fed rate cut was due to implications of global developments for the economic outlook as well as muted inflation pressures even though US domestic conditions remain robust. The FOMC statement did not commit to a further rate cut but it remains a wait-and-see as it says it “contemplates the future path of the target range for the federal funds rate, it will continue to monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective.”

- The latest Trump tariff announcement and China’s retaliation could worsen global sentiment and growth concerns may emerge, and as such raise likelihood of a Fed cut in Sep and in the last few months of this year. Our economics team is looking at a baseline of 100bps (including 25bps cut already delivered) up to 1H 2020 and it looks unlikely that the Fed will cut rates close to the US Presidential election amid moderating growth. The market is pricing in 81/117bps cut next 6 months/2 years.

- **Latest Fiscal and External Balance Outlook:** Overall, growth in US economic activity is likely to slow toward trend as the impulse from the fiscal stimulus fades. The tax plan has not generated a sustained pickup in investment spending. The tax cut and Jobs Act are likely to widen deficit by about $1.5trn over 10 years. The bipartisan budget Act of 2018 to add $320mn in additional spending through FY 2020.

- **Key domestic events and issues to watch in Sep:** ISM mfg (3 Sep); Factory orders, durable goods orders (5 Sep, 25 Jul); NFP (6 Sep); Trade Balance (4 Sep); Jul CPI (12 Sep); Aug retail sales (13 Sep), Conf Board consumer Confidence (24 Sep); GDP qoq (26 Sep); PCE deflator (27 Sep), FOMC (19 Sep).

- **Technical Outlook:** Our call (in the last FX Monthly), on the back of signs of formation of rising wedge (bearish reversal) pattern looking for a move lower towards 97.40 was more than met. DXY traded a low of 97.03 (9 Aug). Subsequently early month weakness was reversed into Aug close. Last seen at 98.50 levels. Mild bullish momentum on weekly chart remains intact albeit stochastics in overbought conditions. Move higher in the near term not ruled out but likely to meet resistance at 98.70, 99 levels. Look for rallies to fade into. Support at 98 (21 DMA), 97.50 (50, 100 DMAs), 97 levels (200 DMA).

EUR: Fiscal Stimulus Can Take Pressure off ECB

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
EURUSD	1.1050 (--)	1.1100 (--)	1.1150 (--)	1.1200 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** EUR could face marginal downside pressure in the near term on growing market expectations for significant ECB easing in Sep, concerns of deeper than expected growth slowdown in EU and political uncertainties in Italy (risk of snap elections remains despite alternative coalition government formed). But downside pressure can dissipate if potential fiscal stimulus measures come through to address Euro-area economic softness (may imply less need for drastic ECB easing). In addition EUR's enhanced status of funding currency may on the contrary provide some buffer against further weakness as risk-off environment (typically in re-escalation of US-China trade tensions) typically see funding currencies including JPY and EUR in demand. On the other hand, possible US-EU trade deal without US imposing tariffs on German car imports takes away another negative risk weighing on the EUR.
- **Political Situation in Italy Works in Both Directions:** Question remains if fresh elections will be held and this is **dependent on whether the alternative coalition government (formed between Five Star Movement and Democratic Party and led by Conte) can manage to sort out its cabinet appointments**. PM Conte has about 1 week or so. The new coalition is perceived to be fragile with total seats at 339 (vs. previous coalition government (between 5SM and Northern League at 352 seats) and both parties had a history of differences in political bias. While there may be temporary clarity on the political front for now, we caution that uncertainties remain. **Uncertainty on political front typically weighs on EUR** in the run-up to event day and **sell-off tends to stabilize on clarity of outcome post-event risk**.
- **Expect Some Form of ECB Easing in Sep:** We expect limited degree of precautionary easing from ECB which include 10bps cut to current deposit rate of -0.40% and re-introduction of TLTRO-III as planned with **rate at par to MRO** (as opposed to +10bps above the average rate applied to MRO) over the life of the respective TLTRO and as low as the average deposit facility rate +10bps for banks exceeding a certain lending benchmark (tiered system). We **stopped short of calling an all-out easing** (i.e. deeper cut to deposit rates and QE) in part to avoid expending its monetary policy tools too soon and in part due to limitations on how effective further rate cuts may be on the economy when key policy rates are already negative.
- **Fiscal Stimulus Can Partially Mitigate EUR Weakness:** Potential appointment of Lagarde as the next ECB President (Nov-2019) could see her pushing the European governments to work more on fiscal policies to stimulate growth rather than the solely relying on the use monetary policies. For instance chance of German fiscal stimulus (~EUR50bn) to address economic softness may suggest lesser reliance on monetary stimulus. This takes the pressure off ECB to do more

(unconventional monetary policies) and help to mitigate against EUR weakness.

- **Downside Risks to EUR Forecasts:** (1) ECB launches an all-out easing program incorporating restart of QE; (2) US-EU trade talk progress dials back; (3) Hung parliament outcome in the event that snap elections are held in Italy.

- **Growth and Inflation Outlook: Euro-area economy expanded at a slower pace of +0.2% q/q in 2Q**, (vs. 0.4% in 1Q). Growth slowdown was seen broadly across most key economies in Europe including Germany, France, Spain, Belgium and Austria while Italy failed to record any growth for the 4th time in 5 quarters. In terms of activity and sentiment, German's data still look soft, in particular, industrial production, retail sales, IFO expectations, ZEW survey expectations, etc. PMIs for Euro-area including Germany and France showed signs of stabilisation. In particular France manufacturing PMI swung into expansionary from contractionary territory.

- **Headline CPI estimate slowed further to 1% y/y in Jul, down from 1.3% y/y in Jun.** Services inflation (possibly due to packaged tours in Germany) was the main drag, followed by energy prices. Core inflation held steady at +0.9% y/y in Jun. CPI remains well below ECB's sub-2% goal. In the recent ECB's release of latest survey of professional forecasters, 2019 inflation was revised lower to 1.3% (from 1.4% previously).

- **Monetary Policy Forecast:** We expect limited degree of precautionary easing from ECB to counter against downside risks to growth at the upcoming Governing Council meeting, scheduled on 12th Sep. We acknowledged that our expectations are much milder compared to street expectations of up to 20bps cut to deposit rate and QE of EUR50-60bn monthly purchase.

- A combination of modest rate cut of 10bps to current deposit rate of -0.40% is likely while TLTRO-III **will be launched as planned but we think the rate will be at par to MRO** (as opposed to +10bps above the average rate applied to MRO) over the life of the respective TLTRO and as low as the average deposit facility rate +10bps for banks exceeding a certain lending benchmark. We expect **Main Refinancing operations (MRO) to remain on hold at 0%** but see **some risk to marginal lending facility being lowered by 25bps to 0%** (from 0.25% currently). We still **do not expect ECB to re-introduce asset purchase program** (aka. QE) at this stage but **believe ECB will continue to sound dovish and caution on the use of QE** if economic and financial conditions continue to deteriorate further. We refrain from calling an all-out easing (i.e. deeper cut to deposit rates and QE) in part to avoid expending its monetary policy tools too soon and in part due to limitations on how effective further rate cuts may be on the economy when key policy rates are already negative (negative impact on banking system may outweigh benefits of lower interest rates and lower rates does not necessarily translate into loan pick-up (demand side issues). In addition, the potential appointment of Lagarde as the next ECB President (Nov-2019) could see her pushing the European governments to work more on fiscal policies to stimulate growth rather than the solely relying on the use monetary policies.

- The last GC meeting (25 Jul) suggests that ECB is setting the stage for another dosage of monetary stimulus soon. In particular ECB said that "a **significant degree of monetary stimulus** continues to be necessary to ensure that financial conditions remain very favourable and is supportive of Euro-area expansion". ECB also said that they are examining **a tiered system** for reserve remuneration – lowering charge that banks pay to park their excess cash at the ECB and could **re-introduce QE**. Overall, the ECB **expects its key interest rates to remain "at their present or lower levels"** at least through 1H 2020. But not all members are in agreement with monetary stimulus. Bundesbank's Weidman said (27 Aug) that it would be "wrong for us to act for action's sake"… speculation over interest rate cuts or QE "doesn't do justice to the EU-area's latest economic data". He also warned about blindly reacting to calls for more central bank support despite expectations that inflation will continue to fall short of ECB's goal of below but close to 2%. He said that "what matters is that we are on track to hit that target… if our journey experiences occasional delay for good reasons, that's acceptable". ECB's Knot said (29 Aug) that the Euro-area economy is not weak enough to warrant the resumption of bond purchases but he is open to interest rate cut. He added that QE is appropriate policy tool if deflation risks come back but that's not the outlook assessment for now. Meanwhile Finnish Governor Rehn called for a package of measures that beats expectations while Slovakia's Kazimir said a "broad consensus" is needed to ensure ECB's credibility and is leaning towards policy action in Sep.

- Minutes of the last meeting noted "combination of instruments with significant complementarities and synergies, such as the combination of rate cuts and asset purchases – was more effective than a sequence of selective actions". Elsewhere in the accompanying statement/press conference post-ECB meeting, Draghi said the economic "outlook is getting worse and worse… in manufacturing especially and it's getting worse and worse in those countries where manufacturing is very important". But he did say that the risk of a broad recession is "pretty low". On inflation, he said that CPI remains well short of ECB's target of sub-2%.

- **Latest External Balance Outlook:** Euro area's current account surplus narrowed to EUR18.35bn in Jun, from EUR30.29 in May. This is the lowest surplus since Jan-2017. Both goods and services trade surplus fell. In the 12 months to Jun, current account surplus fell to EUR318bn or 2.7% of GDP (vs. EUR391bn or 3.4% of GDP in the same period last year). ECB had earlier expected current account surplus to narrow further to 2.7% of GDP in 2019 and 2.5% of GDP in 2021.

- **Key domestic events and issues to watch:** Aug mfg PMI (2 Sep); Jul PPI (3 Sep); Aug services PMI, Jul retail sales (4 Sep); 2Q final GDP (6 Sep); ECB meeting; Jul industrial production (12 Sep); Jul trade (13 Sep); Sep ZEW survey expectations (17 Sep); Aug CPI (18 Sep); Jul current account (19 Sep); Sep consumer confidence (20 Sep); Sep prelim PMIs (23 Sep); Sep final consumer confidence (27 Sep).

- **Technical Outlook:** Early gains in Aug faded into the close. Last seen at 1.1050 levels. Weekly momentum turned mild bearish. Risks are tilted to the downside. Immediate support at 1.10. Break below could see EUR trade lower towards 1.0860 levels (76.4% fibo retracement of 2017 low to 2018 high). But we caution that EUR near oversold conditions (as seen on stochastics indicator) could see some limited room to the downside. Resistance at 1.1190 (61.8% fibo, 50, 100 DMAs), 1.1270 (200 DMA).

GBP: Can Rise amid Kitchen-Sinking Tactic

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
GBPUSD	1.2000 (--)	1.2400 (--)	1.2500 (--)	1.2600 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** Bearish bias on GBP remains amid business/investors' uncertainties arising out of risk of hard brexit (on 31st Oct) and its prolonged slowdown on economic growth, investments. But we caution that stretched GBP shorts positioning (near 30-month high) may suggest that further downside could be sticky. This is especially so when bad news on hard brexit are already getting into the price and if signs of positive progress were to gather traction, stale GBP shorts could well be squeezed, resulting in corrective and sharp rebound for GBP.

- **Parliament Suspension Stokes Fears of Hard Brexit:** PM BoJo's plan to suspend parliament was approved by Queen (announced 28 Aug). House of Commons will be suspended no earlier than 9th Sep and no later than 12th Sep till 14th Oct when the Queen's speech will take place. Parliament will return on 3 Sep and sit for less than a week before going into recess again till 14th Oct ahead of EU summit (17 – 18 Oct) and Brexit day (31 Oct). Doomsday kind of headlines-driven fears posing downward pressure on GBP is very likely. **Parliament suspension means is there is less time for the Opposition to pass any law to stop no-deal brexit on 31st Oct and less time for the parliament to debate and chart the course of Brexit.**
  - Earlier, Labor party leader Corbyn hosted talks with opposition parties and it was agreed **that passing a law to force a brexit delay may be more effective that replacing the current government** with a caretaker government. With parliament shutdown, the opposition party may struggle to pass any law ahead of 31st Oct brexit date. Anyways we opined that case of brexit delay instead of passing a motion of no-confidence is more positive on GBP as the latter would add to uncertainty.

- **We Argue Otherwise.** A parliament suspension also mean there may be less political noises especially when there is a deep divide within the House of Commons on what they want out of Brexit. We reiterate that BoJo is forcefully executing the art of negotiation as this gives him additional bargaining chips to show the EU that UK is prepared for no-deal brexit and this could force the EU to come back to the negotiating as the EU may also not be prepared for no-deal brexit given that EU export more (in terms of goods) to UK than the other way round. Disruption to trade can affect Europe, in particular German, Spanish and French businesses. Vice versa, we believe the UK is probably not prepared for no-deal brexit as well given that services exports to EU is about 7% of UK GDP (vs. 1% of EU GDP). Both parties will stand to lose in no-deal brexit. The optimal outcome will be for both parties to ultimately re-open their lines of communication and compromise towards a modified deal. In this scenario, hard brexit fears should fade and GBP could recover then.

- A United Nations Trade and Development (UNTAD) report showed that EU stands to be the biggest loser, followed by Turkey once UK leaves the EU. On brexit, it will change the ability of non-EU countries to export to the UK market. As of 2018, more than 50% of UK imports came from EU. This gives an idea why EU could lose more from a trade perspective.

- **Tentative Signs of EU biting BoJo's Bait.** On 21 Aug, German Chancellor Merkel gave BoJo 30 days to come up with alternative backstop solution while French President Macron said "I am also, like Chancellor Merkel, confident that with our collective intelligence and will to build should allow us to find an intelligent solution within thirty days…" though he later said that they "will not find a new withdrawal agreement that deviates far from the original". More recently (27 Aug), BoJo had phone calls with European Commission President Juncker and separately with Dutch PM Rutte. A spokesman said that Juncker has repeated his "willingness to work constructively" with PM "and to look at any concrete proposals he may have" as long as they are compatible with what had been agreed. Dutch PM Rutte said that EU is open to any "concrete proposals" from the UK as long as they are consistent with those aims. What this anecdotal evidence means is there seem to be some room for negotiation on brexit deal as opposed to doors shut on previously agreed brexit deal. Though UK is not out of the woods and a no-deal brexit is a base case scenario for most (unlike in previous periods when the base case was soft brexit), bits of potential good progress (either a modified deal or even a delay) coming out of discussions with EU may well provide the much-needed catalyst for the move higher in GBP, especially when GBP short positions is stretched (nearly 30-month high).

- **GBP Remains Exposed to 2-Way Risks:** GBP could: (1) more than undershoot our forecasts if BoJo fails to put together an amended brexit deal that is acceptable by EU and UK parliament or a case of hard brexit with no deal (i.e. disorderly exit) takes place or (2) more than overshoot our forecast if brexit is interpreted to be "market friendly" (characterized by smooth exit with a modified deal or delayed exit). Recovery in investments and growth could come as businesses get more visibility on the road ahead. In this "better" scenario 2, the BoE may need to bring forward its policy normalisation plans. Taken together, GBP could recover more meaningfully via the market sentiment and investor confidence channels (first order effects).

- **If brexit date is not extended and there is no deal agreed (i.e. hard brexit), then there is no transitional agreement.** In this scenario UK will leave EU and will strive to forge fresh trade relations with trading partners.
- A **transitional agreement will only kick in if the amended deal is agreed.** In this scenario, we still believe UK will exit orderly but with a technical delay to get documents/treaties ratified. This transitional agreement is likely to last till 31st Dec 2020 (with an option for extension till end-2022..

- **We retain our mild upward trajectory for GBP (albeit forecast values being revised lower).** This is premised on our base case assumption that calls for a smooth exit (i.e. UK to leave EU with a modified deal by 31st Oct or another brexit extension). Based on our model estimates which take into account current account differentials, interest rate differentials and inflation differentials, GBP's fair value estimate fall in the range of 1.42 – 1.46. This justifies our upward forecast trajectory over the forecast horizon (delayed further into the medium term). The -15% or so deviation (spot to fair value estimate) largely reflects the Brexit premium and should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We hold to our belief that UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term). In the last episode where UK left the ERM back in 1992, GBP saw a period of consolidation (for a few years) at historical lows before the eventual move higher in the following years, where GBP TWI traded above 100-levels in 1998 (from the lows of 80 in 1993-1996) due to buoyant demand fueled by rapid growth of wealth, credit and money. If history is a guide (assuming UK manages the transition well and takes the opportunity to correct its imbalances), its currency may start climbing higher.

- **Growth and Inflation Outlook: UK runs the risk of falling into a technical recession in 3Q, after 2Q GDP unexpectedly contracted 0.2% q/q** (vs. +0.5% q/q in 1Q). Stronger household spending was more than offset by decline in business investment, construction and industrial output while services growth stagnated. Draw-down of stockpiling built in the lead-up to the initial 29th Mar brexit was also cited as a reason for the decline in GDP as that shaved about 2ppts off GDP. There were also reports saying that auto factories brought forward summer maintenance shutdowns to Apr to avoid supply chain disruptions around initial brexit date. Looking on, survey indicators including manufacturing, services and construction PMIs and retail sales rebounded in Jul. Labor market remains robust with unemployment rate at multi-decade low of 3.9% and wage growth steady at elevated levels (3.7% y/y). It may be premature at this stage but is likely UK should manage to escape technical recession.

- **Quarterly Inflation Report (QIR) on 2nd Aug showed that MPC lowered its growth projections for 2019 and 2020 to 1.3%,** down from previous projection of 1.5% and 1.6%, respectively. This is due to increased brexit worries and a slowing global economy. These forecasts assume UK leaves EU with a transitional deal but suggests that growth could be much lower in the event of no deal hard brexit. It also said there is a 1-in-3 chance that the economy will shrink at the start of next year. Inflation is expected to slip below BoE's 2% target in coming months partly because of lower gas and electricity prices. We are cautious on this guidance as the sharp depreciation in GBP and potential stockpiling ahead of brexit on 31st Oct could lead to upward price pressures. 2020 and 2021 inflation forecasts have been revised upwards to 1.9% and 2.2%, respectively, from 1.7% and 2.1%.

- **UK headline CPI rose to 2.1% y/y in Jul,** owing to increases in restaurant & hotel prices, computer games & consoles while clothing and footwear fell by less. On the other hand, downward price pressures can be seen from air, rail and sea transport fares and fuel prices. PPI input prices saw a sequential uptick to 0.9% m/m in Jul (vs. -1.4% in Jun), possibly due to feed-through via softer GBP. Looking on we continue to reiterate that softer GBP (depreciated by nearly 9% since Mar-2019) and higher wage growth may result in higher inflation upticks ahead.

- **Monetary Policy Forecast:** We still expect BoE MPC to keep policy rate and size of BoE balance sheet unchanged at 0.75%, GBP 435bn, respectively at the upcoming meeting on 18th Sep. **Relatively steady CPI (no run-away pressure from BoE MPC's 2% target), with chance of some slight pullback due to lower oil prices and Brexit uncertainty leaves room for BoE to keep policy stance status quo for now.** Maintaining accommodative monetary conditions is what the BoE can do to help support growth amid ongoing Brexit uncertainties. **But inflation may go higher at some stage towards later part of the year amid weaker GBP** (depreciated >9% from the high this year) **and potentially front-loading of stockpiling/imports ahead of *Brexit* on 31st Oct.** Increasingly we see some risks of BoE being stuck in a situation wherethe BoE may need to tighten rates (to arrest inflation) in the face of synchronous easing and brexit uncertainties. This was a risk we have long highlighted - *remain watchful of inflationary pressures as tight labor market is capable of generating domestic price pressures while a case of no-deal brexit could result in sharp depreciation on GBP (brings about higher imported prices and this translates into higher CPI). Sustained rebound in CPI towards 3% again could pressure BoE to hike earlier reluctantly.* This is probably the last thing BoE want to do.

- **External Balance Outlook** UK's current account deficit widened to 5.6% of GDP for 1Q 2019. This was the largest deficit since 3Q 2016 and was driven by imports of gold. The ONS said that stripping out the large imports of gold, UK currency account deficit would have stood at 3.7%. Imports of goods amid brexit stockpiling also contributed to the widening of the current account deficit.

- **Key domestic events and issues to watch:** Aug PMI Mfg (2 Sep); Aug construction PMI (3 Sep); Aug services PMI (4 Sep); Jul IP, construction output, trade (9 Sep); Jul labor report (10 Sep); Aug CPI, PPI, RPI (18

Sep); Aug retail sales, BoE MPC (19 Sep); Aug public finances (24 Sep); 2Q final GDP, current account balance (30 Sep).

- **Technical Outlook:** GBP fell further for the month of Aug. Last seen at 1.2170 levels. Bullish momentum on daily chart remains intact but shows tentative signs of fading while stochastics is showing signs of turning from overbought conditions. Corrective move lower not ruled out in the near term. Support at 1.2150 (21 DMA), 1.2090, 1.2050 levels. However on the weekly chart, we observed a potential bullish divergence in the making. We are bias to accumulate GBP on dips, looking for a move higher. Immediate resistance at 1.2350 (50 DMA) needs to be broken for gains to gather traction possibly towards 1.2440 (76.4% fibo retracement of 2016 low to 2017//18 double-top). A move towards 1.2810 (61.8% fibo) should not be ruled out.

AUD: Fate Tied with China Still, Bottom Not Yet Firm

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
AUDUSD	0.68 (0.69)	0.68 (0.70)	0.69 (0.71)	0.70 (0.72)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** AUDUSD touched a low of 0.6677 in early Aug and hovered within 0.6750-0.6830 for the rest of Aug. This came after the break of the 7 by USDCNY and while the effects of the US-China trade tensions very much manifested in the RMB, AUDUSD displayed relative resilience as certain domestic data started to show some signs of stabilization.

- **We no longer look for a trade deal within the year but we do not look for further escalation either.** That underpins our view for AUDUSD to hover around 0.68 for the rest of the year with risks roughly balanced. We are wary of weakening hiring trends in the construction sector that has contracted more than expected for 2Q. Worsening hiring sentiment could force RBA to lower cash target rate by another 25bps in Oct, as implied by OIS. At the same time, we have been in a seasonally volatile month and the US-China trade tensions have escalated quite a bit. Usually, the weakness is frontloaded before the actual tariff event and any delay in tariff by the US (for 1^{st} Sep, 1^{st} Oct or 15^{th} Dec) followed by China's should see AUD rally towards 0.69-0.70. **So we actually expect AUDUSD to swing between 0.66-70 for the rest of the year with some potential for recovery in Sep in case of progression in the US-China trade talks.**

- As we move into Sep, we continue to monitor domestic data releases including PMI-mfg prints and China's Caixin PMI-mfg for further AUD cues along with any signs of further escalation between the US and China that could weigh on the AUD. The trajectory for AUDUSD is held at 0.68 for the rest of this year as we see potential for recovery for this pair should data continue to show promise and that could unwind expectations for RBA to cut rates. At the point of writing, OIS implied RBA to lower cash target rate by another 25bps in Oct. That would be after the quarterly numbers are out including 2Q GDP and current account. Within Sep, we also get a quarterly sectoral breakdown of jobs numbers along with the usual Aug labour report to have a feel of whether hiring sentiment has deteriorate. Minutes of the Aug meeting suggest that RBA sees boost from infrastructure spending, tax cuts as well as the two rate cuts delivered already.

- **Growth and Inflation Outlook:** Business sentiment still seems a tad mixed but we are writing ahead of the 2Q Capital expenditure release at the end of Aug. As we have noted in our higher frequency publication, data seems to show nascent signs of improvement with housing price data recovering (CoreLogic was up +0.1%m/m from previous -0.1%). That might have given a modest boost to private consumption, which has been weighed by depressed wage growth and high household debts. Its proxy retail sales was up +0.4%m/m vs previous +0.1%. Still, stripping away the price effects, retail sales rose by +0.2%. Although there are tentative signs of stabilization in the housing sector, the persistent decline in home prices still crimped on consumer sentiment. A look at the historical business survey and housing data suggest that the stabilization in established housing prices in 2011 took around a year before investors and consumers start to regain confidence. There are still signs of uncertainty including the deterioration in the business conditions score as surveyed by NAB to 2 from 4 although business confidence for Jul has improved to 4 from 2.

- The Jul labour report was up 41.1K consisting of 34.5K full time and 6.7K part-time. Labour force participation rate rose to record high of 66.1%, encouraged by the hiring momentum, leaving jobless rate steady at 5.2%.

- Australia's manufacturing outlook brightened in Jul with the AiG Performance of Manufacturing index firmer at 51.3 from previous 49.4. PMI Mfg also came in decent at 51.6 vs. previous 52.0. That said, these improvements are still quite nascent and only at best, indicate signs of stability. According to the latest NAB business confidence survey, sentiment in this sector is still quite soft and understandably so given the trade-war that still wages between the US and China.

- Construction work completed fell in 2Q by -3.8%q/q vs. estimated -1%. This could bode ill for hiring in this sector.

- Based on the last release, 2Q CPI came in a tad higher at 0.6%q/q vs. previous 0.0% (expected 0.5%). Underlying inflation (taken as the average of the trimmed mean and weighted median) is around 1.4%y/y, steady from previous quarter. Tradable component rebounded rather sharply to 1.2%q/q from previous -0.6% although non-tradables weakened to 0.2%q/q from previous 0.3%, which still suggests soft domestic demand. The acceleration was rather broad-based across all sub-components with notable rise in food inflation (+0.8%q/q vs. prev. -0.3%), housing (+0.8%q/q vs. flat).

- **Monetary Policy Forecast:** RBA continues to reiterate that the central bank is ready to cut if necessary (specifying accumulation of additional evidence) and there was even a discussion on "unconventional measures" in the Aug meeting. It would take further deterioration in the labour market conditions for RBA to take cash target rate from 1.00% to 0.75% and the next few monthly labour reports will still be closely monitored.

- **So what are the risks of further deterioration?** We note that some domestic data has improved marginally. Insofar, we saw nascent signs of stabilization in housing prices, better Mfg data, firmer than expected CPI for 2Q, wage growth as well as an upside surprise in the Jul labour report. However, we also note that business confidence remains weak in manufacturing, recreation according to the NAB business survey. Construction output has been weak and that could eventually affect hiring in that sector. Signs of stabilization could still be threatened as the US-China trade war escalates and weaken China's economic growth further. That could also, in turn, jeopardize our view for no more cuts to the cash target rate this year (for now) as RBA had already done two pre-emptively this year. With trade negotiations unlikely to end anytime soon, we see a real risk that these signs of stabilization could be threatened and RBA to be forced to cut rates by another 25bps in Oct.

- RBA Deputy Governor Debelle, in his recent speech, said that the "lower bound" of policy rates could be "similar to overseas peers", interpreted to be around 0.25-0.5%. In that perspective, AUD may still need to adjust lower as terminal rates, based on futures implied is around 0.4%.

- **Latest External Balance Outlook:** The next report on current account for 2Q will be released in Sep. Based on available data, current account deficit narrowed to A$2.9bn (s.adj) for 1Q from previous - A$6.3bn. We may continue to see improvement in the current account as Australia continues to show trade surplus. Apr trade surplus came in at A$4.87bn. Terms of trade continues to improve, possibly due to the depreciation in the currency vs. its trading partners as well as the rise in commodity prices. Export price index slowed to 3.8%q/q from previous 4.5%. Imports price index accelerated to 0.9%q/q from previous -0.5%.

- **Latest Fiscal Outlook:** Treasurer Josh Frydenberg projects a fiscal surplus of $7.1bn for the year through 2020. Post budget, PM Scott Morrison announced a plan to set up an Australian Business Growth Fund that is projected to grow to A$1bn when it matures, aimed at creating 250K new small businesses over the next five years. The government has recently passed the A$158bn tax-cut package that could be supportive of household spending.

- **Key domestic events and issues to watch in Sep:** AiG Perf of Mfg index (Aug), CoreLogic House, M-I inflation (Aug), Commodity index (Aug) on 2nd Sep; BoP current Account (2Q), retail sales (Jul), RBA Meeting on the 3rd; GDP (2Q) on 4th; trade data (Jul) on 4th; foreign reserves (Aug); home loans, investment lending and owner-occupier loan value (Jul) on 9th; NAB business conditions, confidence (Aug);

Westpac consumer confidence (Sep); Minutes of the RBA Sep Policy Meeting on the 17th; Labour report (Aug) on the 19th; CBA PMI Mfg (Sep P); Aug Job vacancies (Aug).

- **Technical Analysis:** Even as this price remains heavy, the doji in the weekly chart suggests an immense indecision in the price action. This pair remains in a falling wedge pattern and support is intact at around 0.6677. Look for at least a retracement towards 0.6850 before 0.6940.

NZD: Bearish Outlook but Some Hopeful Factors

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
NZDUSD	**0.6400** (0.6500)	**0.6400** (0.6700)	**0.6600** (0.6800)	**0.6600** (0.6800)

No Change to Previous Forecast

- **Motivation for the FX View: We retain a bearish outlook on NZD,** amid growing concerns of global growth slowdown (spilling over to domestic level) and deterioration in market sentiment amid recent flare up of trade tensions between US and China. Our forecasts have also been revised lower to reflect the change in our house view on US-China trade disputes - now looking for a trade deal to be delayed to sometime in 1H 2020. But we see partial-mitigating (and hopeful) factors against further NZD weakness coming from potential Fed easing in Sep (which could temporary curtail USD strength) and a watch-and-see RBNZ (after surprising markets with 50bps cut at the last meeting).

- We believe the surprise and aggressive move to front-load rate cut was intended to deliver maximum effectiveness to meet its dual policy objectives of inflation and employment but also to play catch-down with its RBA peer. In light of the global wave of monetary easing, it is also very likely RBNZ does not want to stand out in the crowd of doves as that would result in a firmer NZD and could result in tighter financial conditions. **With OCR now at historical low of 1%, the bar for further rate cut may be set higher. RBNZ Governor Orr had said (23 Aug) that RBNZ could afford wait-and-watch before deciding on further action to support the economy.**

- But caution remains as RBNZ could still ease further if need arises especially when synchronous monetary easing gains traction in most parts of the world including US and Asia. In addition RBNZ shared (on 23rd Jul) that they have begun a project to refresh unconventional monetary policy strategy and implementation, albeit at a very early stage. There was no further detail beyond the disclosure to Official Inflation Act in requesting for work on non-standard policy measures. **Though we do not expect RBNZ to join ECB, BoJ to unleash unconventional QE-type of monetary policies in the near future,**

the mere mention of conducting such a project can further reinforce the dovish bias of RBNZ.

- **Growth and Inflation Outlook: 2Q GDP will be released on 19th Sep. Slump in manufacturing PMI for Jul into contractionary territories (48.2 vs. 51.1 prior) and slower retail sales in 2Q (0.2% q/q vs. 0.7% in 1Q) raise caution that 2Q GDP growth may decelerate further,** especially after the sequential uptick to +0.6% q/q in 1Q. Uptick then was supported by goods-producing industries, in particular construction and manufacturing sectors. But growth in services sector (which account for 2/3 of GDP) decelerated. Retail trade & accommodation, transport, drop in tourist arrivals surprised to the downside. On the expenditures side, private consumption was soft but business investment and net exports came in stronger than expected.

- **RBNZ expects NZ growth to remain subdued and have lowered growth forecasts through 2019 and 2020 to 2.7%, 2.4%, respectively** (as of the last MPS, Aug 2019).

- On inflation, RBNZ noted that most measures of core inflation remain below 2%. Subdued inflation partly reflects low imported inflation and this is expected to decline in the near term before gradual convergence to below its long-term average. RBNZ also noted on weak pricing behaviour.

- **Headline CPI re-accelerated to +0.6% q/q in 2Q** (vs. +0.1% in 1Q) owing to higher petrol prices and housing cost. Petrol prices (tradable inflation) are transitory and the upward pressure on petrol prices is likely to ease off in 3Q as oil prices stabilise. As such the next print for inflation could ease as oil prices slipped and slowing global growth momentum amid US-China trade tensions feed-through to NZ economy. On annual basis, headline CPI rose +1.7% y/y in 2Q, from 1.5% in 1Q. The uptick is in line with RBNZ and market expectations. Non-tradeable inflation remain steady at 5-year high of 2.8% y/y

- **Monetary Policy Forecast:** We expect **RBNZ to keep OCR on hold at 1% at the next MPC meeting on 25th Sep after the surprise 50bps cut back in Aug MPC** to allow for its effects to work its way into the economy. In addition, **RBNZ Governor Orr said (23 Aug) that RBNZ could afford wait-and-watch before deciding on further action to support the economy.**

- At the last MPC meeting (7th Aug), RBNZ surprised markets with an upsized easing by **cutting OCR by 50bps to 1%**. Most analysts in the markets including ourselves were looking for 25bps. We did expect the RBNZ to do more to play "catch-down" to RBA (already cut rates by 50bps in Jun and Jul) but stopped short of calling for 50bps cut as domestic macro conditions (i.e. unemployment rate at 11-year low, sequential uptick in wage growth) do not seem to warrant an urgency to ease by this magnitude. Accompanying MPS emphasized that MPC members were still very focused on inflation below 2% target (one of the key mandates) and are concerned of slower domestic growth through trade, financial and confidence channels. In particular MPC members noted that *heightened global uncertainty was reducing investment and suppressing trading partner growth…* and this highlighted the *risk of larger or more prolonged slowdown in global growth*. On the decision to cut OCR by 25bps or 50bps, the MPC debated the relative benefits and reached a consensus that larger initial monetary stimulus would best ensure inflation and employment objectives are met.

- In terms of post-MPC RBNZ speaks, RBNZ Governor Orr said (8 Aug) that threat of US-China trade issues has lingered too long, creating global economic uncertainty. He also repeated that negative rates are a possibility and low positive interest rates are just as effective as ever. Assistant Governor Hawkesby said that the shock 50bps cut would help return inflation towards the midpoint of its RBNZ target range and <u>one of the benefits of doing 50bps cut is that it reduces the probability on the use of unconventional tools</u> (negative interest rates or even QE). When asked whether a weaker currency was part of RBNZ's thinking, Hawkesby said that "we are conscious of the that the move was more than expected and more than was priced into the market, so the fact that the currency is weaker is not a surprise to us". He further added that <u>a lower currency is one part of the transmission mechanism in addition to all other avenues that interest rates feed their way through into the economy</u>.

- **External Balance Outlook:** NZ current account deficit narrowed to -3.6% of GDP in 1Q from -3.8% of GDP in 4Q 2018. This was due to an improvement in trade balance due to higher dairy exports and a slowdown in imports.

- **Key domestic events and issues to watch:** 2Q terms of trade (2 Sep); 2Q mfg activity (9 Sep); Aug food prices (12 Sep); Aug Mfg PMI (13 Sep); Aug services PMI (16 Sep); 2Q current account balance (18 Sep); 2Q GDP (19 Sep); Aug trade, RBNZ MPC (25 Sep); Sep consumer confidence (27 Sep); Aug building permits, Sep business confidence (30 Sep).

- **Technical Outlook:** NZD remains under pressure this month, breaking below 0.63-handle (30 Aug) for the first time in 4 years. Pair was last seen at 0.6295 levels. Bearish momentum on daily chart remains intact while stochastics is in oversold conditions. Near term technical bias remains skewed to the downside. Support at 0.6250, 0.6130 levels. But at the same time we are cautious on how much lower the pair can test as oscillator indicator is flashing oversold conditions. A potential falling wedge pattern - bullish reversal and bullish MACD (on the weekly charts) could possibly play out at some point

JPY: Boosted by Tariff Threats

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDJPY	106 (108)	105 (107)	106 (--)	106 (--)

Previous Forecast in Parenthesis.

- **Motivation for the FX View:** Forecasts for the second half of this year was adjusted downwards, largely factoring in safe-haven flows seeking refuge in the yen in times when global relations between major powers are so volatile. The rush to yen was rapid at the turn of the month, when Trump announced new 10% tariffs on further $300bn of Chinese imports, and the USDJPY pair saw a ~300pips tank over the course of a few trading days. Major movements since then have been due to tariff-related announcements as well, whether it's the delaying of certain tariffs by the US (~150pips spike), or the announcement of retaliatory tariffs by China (~200pips tank, followed by sharp recovery). The level of trust between US and Chinese authorities is probably at new lows currently, and the possibility of a deal by year-end has similarly diminished. More concrete signs of positivity from talks are more likely to come through in 2020 (perhaps before the Nov 2020 US elections) when sufficient economic damage on both sides force US and China back to the negotiation table, in which case USDJPY could rise modestly (i.e., yen softening) then.

- We note that the latest round of tariffs and counter-tariffs could have arguably magnified Fed's dovish slant somewhat. Given that the US has a tad more room for easing compared to BoJ, yield differentials could narrow in JPY's favour (although this would likely take time to play out). Further, concerns over domestic growth, expected VAT imposition in Oct, as well as negative drags from the Korea-Japan trade spat, could also hit Japanese equity market sentiments over time. A step-down in Japanese equity performance could bolster Yen performance (i.e., down-move in USDJPY) in 4Q 2019, and despite potentially moderating global tensions in 2020, continue to support the yen somewhat next year.

- We note that the yield differential between Japanese 10 year bonds and US 10 year bonds have narrowed from -2.7% at the start of the year to around -1.7% now. Chair Powell's speech at Jackson Hole was being interpreted as Fed being more open-ended and flexible with regards to policy, as he dropped a reference to mid-cycle adjustment to policy. This gave the impression that the Fed may well be closer to further easing than before. Meanwhile, it is unlikely that negative yields in Japan (-0.277% for 10 year government bond as of writing) can get much lower. Any signs of further yield compression would be supportive of the JPY.

- Nonetheless, anecdotal evidence and fund flow statistics suggest that yen rallies may be capped due to one key channel—Japanese residents may be taking advantage of the stronger yen to send funds overseas for higher returns. Overseas portfolio and direct investment outflows from Japan jumped to JPY28.2tn (~US$266 billion) in 1H 2019, up 28% from 2H 2018. In current conditions, Japanese investors can potentially get >1% from some currency-hedged DM sovereign debt, while domestically 10-year bonds have negative yields. This supports our caution against projecting the USDJPY at below 105.

- More recently, the Nikkei 225 saw some softness, dipping to as low as 20,111 in early Aug from around 21,521 at end-Jul, alongside the re-escalation in US-China trade tensions, before recovering to around 20700 as of writing. Domestically, a softening in both the Economic & Social Research Institute's Leading and Coincident Business Cycle Indicators likely added to growth concerns as well. The planned sales tax hike (from 8% to 10% on 1st Oct) is finally taking place, after two prior delays. There are some mitigating measures, i.e., some exemptions to certain necessities, earmarking of tax revenue for spending on social services, but these are unlikely to significantly mitigate the decline in consumption. The ensuing growth drag could similarly weigh on Japanese equities, supportive of the JPY in 4Q.

- The latest developments in the Korea-Japan spat shows that relations between the two countries are seeing two-way swings. There were signs of more reconciliatory tones on both sides during the anniversary of Japan's WWI surrender. JSR's (a major Japanese materials maker) receipt of an export permit to continue supplying components to South Korean customers also helped ease market worries. Nonetheless, recent concerns raised by South Korean officials over radiation from the crippled Fukushima nuclear plant, including requests for independent ration checks at Japanese Olympic venues and separate cafeteria for South Korean athletes, have likely caused relationships to sour again. South Korea's decisions to downgrade Tokyo on its own trade whitelist, and to end a military intel-sharing pact with Japan, were also widely seen as retaliatory measures against Japan.

- Repercussions for Japan are starting to emerge, and could potentially worsen going forward. The public backlash in South Korea against Japanese products appears to be gathering momentum, and has started to dent sales of a wide array of items from Asahi beer to Uniqlo clothing. The impact on apparels and luxury cars could potentially take some time to play out. We see these developments as posing a drag on the Japanese economy at a time when growth momentum is already slow. We note that while the Japanese economy is generally less reliant on South Korea—i.e., Japan buys $32.4bn worth of goods from South Korea, mostly raw materials, but sells $52.8bn worth of good, including critical electrical intermediate products, to it—Korea could still retaliate via restricting tourism, for instance. South Koreans rank second among tourist arrivals to Japan, and Korean visitors to Japan were already down 7.6%y/y in July.

- **Growth and Inflation Outlook:** Japan's July industrial production (0.7%y/y vs. -3.8% in Jun) showed its first positive reading after five months of contraction. Autos supported the rebound, but petroleum and coal products, as well as electrical machinery, were drags on growth. Corporate plans for production point to an increase in Aug before a dip in Sep, which could still lead to a weak outlook for 3Q on balance. The Economic & Social Research Institute's Leading and Coincident Business Cycle Indicators softened to 93.3 and 100.4 in June, from 94.9 and 103.4 in the previous month. Meanwhile, consumer confidence had dipped to 37.1 in Aug from 37.8 in Jul. On a brighter note, the prelim Aug Jibun Bank PMIs seem to paint signs of resilient growth momentum, coming in at 49.5 for Manufacturing and 53.4 for Services, compared to 49.4 and 51.8 prior. On balance, growth indicators continue to indicate soft, but non-recessionary outcomes for the economy.

- Exports came in at -1.6%y/y in Jul, compared to -6.7% in Jun. Private consumption in 2Q improved from the -0.1% q/q in 1Q, to 0.6%q/q in 2Q. Jul retail sales came in worse better than expected (-2.0%y/y vs. -0.7% expected), which could imply weak consumption growth momentum for 3Q. Various analysts have mentioned that there does not seem to be much front-loading of purchases ahead of the sales tax hike this time round. Consensus estimates are for the Japanese economy to expand by a modest 1.0% in 2019 for now, improving from the 0.7% estimate previously. With both external and domestic challenges to overcome, consensus figures also expect growth to dip further to 0.4% by 2020.

- Headline CPI slowed to +0.5% y/y in July (vs. +0.7% y/y in June) due to softness in food and energy prices. Core inflation, which excludes fresh food, came in at +0.6% y/y (unchanged from June). Inflation is expected to ease further alongside cheaper mobile phone charges, as well as free pre-school education starting in Oct. A separate core gauge that strips out prices of fresh food as well as energy posted a 0.6%y/y gain, up from 0.5% in June. Broadly tame inflationary pressures suggest that BoJ will need to persist with its ultra-loose monetary policy for an extended period, if it's reluctant to change its 2% inflation target.

- **Monetary Policy Forecast:** As expected, the MPC voted 7-2 to keep monetary policy at status quo at the meeting on 30th Jul, with yield curve control at -0.1% for short term rates and 10Y JGB yield at around 0%; asset purchase of JGB holdings, ETF and J-REIT will be maintained at JPY80tn, JPY6tn and JPY90tn, respectively. BoJ intends to maintain "the current extremely low levels of short- and long-term interest rates … at least through around spring 2020". There was also a new addition at the end of the statement—"will not hesitate to take additional easing measures if there is a greater possibility that momentum towards achieving the price stability target will be lost".

- We note that while BoJ retained its dovish slant and reiterated its commitment to additional easing if needed, there was still a lack of clarity on the type of tools it can credibly rely on to deliver further easing. The characterization of growth/inflation risks in the statement also seemed to imply that any further easing could be more likely triggered by "developments in overseas economies", rather than domestic events (e.g., consumption tax hike). Interestingly, the two (voting) dissenters also argued against the manner in which additional easing might be triggered, i.e., the phrasing of "…if there is a greater possibility that momentum towards achieving the price stability target will be lost". They largely felt that this particular form of forward guidance was relatively vague, and needed to be clearer with regards to the price stability target. On balance, markets' immediate reaction to the statement was relatively muted.

- Shirai, a former BOJ Board member, recently commented that falls in JGB yields could increase the likelihood of a lowering of the short-term negative interest rate by BOJ. Nonetheless, this might not be aggressive nor immediate (i.e., next policy decision on 19 Sep), unless the strength of the yen becomes increasingly worrisome for the BOJ (maybe if USDJPY breaks past 105, and shows clear signs of heading towards 100.) Another potential "easing" option might be to allow a wider trading range on the 10-year JGB. However, this runs the risk of causing the yield curve to invert.

- **Latest External Balance Outlook:** Current account surplus narrowed for the third consecutive month in Jun to JPY1.21tn. For Jul, the trade balance turned negative (-JPY249.6bn vs. +JPY589.6bn prior), as imports (-1.2%y/y) contracted by a softer extent compared to exports (-1.6%y/y). We note that exports have recorded y/y declines for 8 straight months since Dec 2018. The weakness in exports continued to come from the semiconductor segment and auto parts. Exports to Asia had slid 8.3%y/y, following an 8.2% fall in June, whereas exports to the US accelerated (+8.4%y/y vs. +4.9% prior). We note that Japan's dispute with South Korea is a pertinent concern for the trade outlook. South Korea accounted for about 7% of Japan's exports in 2018.

- **Key domestic events and issues to watch:** 2Q Capital Spending (2 Sep), Aug PMI Mfg (2 Sep); Aug PMI Svcs, Composite (3 Sep); Jul ESRI Leading, Coincident Indices (6 Sep); Jul Current Account Balance (9 Sep), 2Q Final GDP (9 Sep); Aug PPI (12 Sep); Jul Core Machine Orders (12 Sep); Jul IP (13 Sep); Aug trade (18 Sep); Jul All Industry Activity Index (19 Sep), BOJ Policy Decision (19 Sep), Aug CPI (20 Sep); Sep Jibun Bank Prelim PMIs (23 Sep), Aug Retail Sales (30 Sep); Aug Prelim IP (30 Sep).

- **Technical Outlook:** Pair last seen around 106.35. It has seen wild swings recently on risk-on/risk-off instances, alongside tariff-related announcements by US/China and shifts in market views on trade policy outlook. Daily momentum is mildly bullish and stochastics are inching upwards towards near-overbought conditions. Bullish divergence earlier this week has played out with the recent up-move. The bearish trend channel since April remains largely intact, and could signal room for further downsides from current level. Support at 106.20 (21 DMA), then 104.90 (Jan flash-crash low). Resistance at 106.90 (50% Fibonacci retracement from early Aug high to recent low), 107.30 (50 DMA)..

RMB: Bears Could Run into Fatigue

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDCNY	7.12 (7.00)	7.20 (6.96)	7.18 (6.90)	7.15 (6.85)
USDCNH	7.12 (7.00)	7.20 (6.96)	7.18 (6.90)	7.15 (6.85)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The break of the 7 came right after we sent out the last FX Monthly dated 2nd Aug warning that *RMB* May *Not Shy Away from 7 This Time*. Should the US levy 15% on an estimated $112bn* (estimated by PIIE) of Chinese imports on 1st Sep and China already announced to increase its tariff (albeit in varying rates) on $75bn of US goods split over 1st Sep and 15th Dec (crude oil and soybeans attracting 5% tariffs within the first tranche), USDCNY and USDCNH could continue to trade higher. The track record of Trump following through with his threats before also means that hardly any positivity is in the price at this point. Recent comments out of China's MOFCOM Gao on "focusing on removing new tariffs" have been a little more hopeful and we think that the CCAF has been too strong to be sustainable for a long period. Both China and the US seem to be signaling intensive dialogue and we see a potential for a correction lower past the 7.10-figure towards 7.07 for the USDCNY.

- We viewed the break of the 7 as not just a policy signal to allow RMB to cushion the impact of upcoming tariffs but a message to Trump that the goodwill has been lost when he declared more tariffs on them. In other words, the break of the 7 is a deliberate decision by China. USDCNY reference rate has been capped under the 6.90 during the escalation of trade tensions between the US and China in May with the use of countercyclical adjustment factor but the countercyclical adjustment factor was hardly present on the day the USDCNY reference rate was fixed above the 6.90-level for the first time since last Dec and that had triggered USDCNY and USDCNH to rally above the 7.00. It is also clear that with the break of the 7, PBoC may allow the RMB to depreciate should there be another round of tariffs beyond 15th Dec. However, just as the policy messages were sent in USDCNY fix, the strong CNY fix recently suggests that something positive could be brewing, at least in the short-term.

- **Details on the Next Round of Tariff:**
  - 1st Sep
    - US tariff on China: Estimated $112bn of Chinese imports (untaxed) will be taxed at 15%.
    - China tariff on US: More Tariffs on $75bn of US Goods split between 1st Sep and 15th Dec. 5% more tariff on soybeans and crude oil starting on 1st Sep.

- 1^{st} Oct
  - US tariff on China: Existing 25% tariffs on some $250bn imports from China would rise to 30% on 1^{st} Oct.

- 15^{th} Dec
  - US tariff on China: Estimated $160bn of Chinese imports (untaxed so far) will be taxed at 15%.
  - China tariff on US: More Tariffs on $75bn of US Goods split between 1^{st} Sep and 15^{th} Dec. The suspended extra 25% duty on US cars will resume on 15^{th} Dec, with another 10% for some vehicles, taking total tariffs on US origin cars to be as high as 50%.

- **PBoC has kept the RMB on the leash with its daily USDCNY reference rate fixed consistently under estimated ranges by private analysts with the use of the countercyclical adjustment factor.** This sends a strong policy signal to the market that the central bank does not desire further yuan weakness for fear of a snowballing effect on yuan depreciation. The 3M CNH Hibor has also been creeping higher, last seen around 3.77%. Rising costs of borrowing in CNH could discourage betting against the CNH. There is also the 70^{th} anniversary of the Founding of the People's Republic of China on 1^{st} Oct and that could mean PBoC would likely keep the RMB somewhat stable. **Our house view now looks for a trade deal only in the first half of 2020. We do not look for a trade deal this year but neither do we look for further escalation. We now adjust our USDCNY forecasts after the break of the 7 to 7.12 for 3Q and then 7.20 for the end of the year as we anticipate China's economy would remain weak and that would require PBoC to ease monetary policy and allow USDCNY to rise at a measured pace beyond 3Q.**

- Other notable events we watch include the next FOMC meeting on the 18^{th} of Sep, WTO mini-ministerial meeting in Shanghai (early Nov) and APEC Summit in Chile (11-17 Nov) that can serve as checkpoints for trade talks.

- As we have changed our view to look for a deal only in 1H 2020 instead of 2019, in an environment of further re-escalation from the part of Trump could continue to mean USDCNY could head towards 7.40-7.50 in the medium term. There are a few critical levels in the medium term to watch. One of which is the 7.30. This was a level derived using a calculation to gauge the amount of RMB weakness needed to nullify the effects of the original 10% tariff on "$300bn" of Chinese goods. That is taking into account the USDCNY at 6.9 before the Aug escalation. Since 23 Aug, Trump had responded to China's retaliation by raising that 10% tariff on the "$300bn" (but estimated to be around $272bn by PIIE) to 15% (split between 1^{st} Sep and 15^{th} Dec) and to also raise the tariff rates on existing $250bn by 5% to 30% ($1^{st}$ Oct). That could mean the USDCNY might have to rise to around 7.73 in order to nullify the impacts of the new tariffs. Another perspective to get a key level is that if we apply the 11% depreciation seen in the CNY against the USD last year that took USDCNY from 6.27-6.97 and apply it to the escalation this year, USDCNY could head above 7.40. All the key levels are still above the 7.1580, where the spot trades now (29 Aug). However, we do not think future moves in the CNY will be as explosive as the break of the 7. Rather, PBoC has shown that it is more determined than before (compared to what was observed in 2018 trade war) to keep the RMB stable.

- **Growth and inflation outlook:** The Caixin PMI-mfg came in firmer than expected at 49.9 vs. previous 49.4. NBS also released a stronger 49.7 for mfg PMI vs. previous 49.4. Breakdown suggests that the larger enterprises supported the headline while purchasing managers in SMEs were less sanguine. The credit growth came in rather poor at CNY1.01trn aggregate financing for Jul. Money supply M2 growth deteriorate to 8.1%y/y from previous 8.5%. New yuan loans was rather dismal at CNY1.06trn vs. previous CNY1.66trn. That had foreboded weak activity numbers that came after. FAI ex rural for the first 7 months of the year softened to 5.7%y/y from previous 5.8%. Industrial production slid to 4.8%y/y from previous 6.3%. Retail sales also came in weaker than expected at 7.6%y/y vs. previous 9.8%.

- Inflation rose to 2.8%y/y for Jul vs. 2.7% previously, underpinned by the surge in food inflation and most notably the meat and poultry subcomponent which rose to 18.2%y/y from previous 14.4% as the African swine flu caused a rise in prices of poultry. Prices of vegetables and fresh fruit could still be elevated due to seasonality effects as well as certain natural disasters. More carefully watched is the Swine Flu that could continue to reduce the production of pork. On the producer front, PPI slipped -0.3%y/y, compressing factory margins and a sign of trade war and weak domestic demand weighing on manufacturing.

- **Monetary Policy Forecast:** On the 20th of Aug, the new Loan Prime Rate (LPR) for 1Y was announced to be at 4.25% vs. previous LPR at 4.31%, 1Y lending rate at 4.35%. The 5Y LPR was set at 4.85%. That was well above the expected rate including our own and underscores PBoC's intent of ensuring that the LPR is reflective of the market-based rates. A less aggressive easing stance may mean that yield differential between the CGB-UST is unlikely to narrow in a hurry, lessening the pressure on the CNY and CNH. We think this suggest that 1) PBoC may prefer to execute the rate reform cautiously. Setting a rate that is too low may increase the risk that this new Loan Prime Rate may not be seen as reflective of current market commercial lending rates and would doom the new Loan Prime Rate from the start. Nonetheless, 2) the lower rates (albeit not much lower) fulfill the promise to some extent that PBoC aims to lower lending rate, as well as an easing stance. 3) The magnitude of the "cut" also goes in line with our view that PBoC is unlikely to engage in aggressive easing although that this magnitude is certainly much smaller than what we had expected.

- That does mean that once the LPR is seen to be more reflective of the market lending rates, the efficacy of a rate cut in the future would be enhanced. This could come via a reduction in the MLF rates, currently at 3.30% for 1Y or TMLF at 3.15%. We anticipate this LPR to head gradually lower from 4.25% and 4.85% gradually. This LPR is announced at 9.30am on the 20th of every month and the next is simply 20th Sep. To some extent, the gradual easing signal should be supportive of the local bonds and not too negative for the CNY with the support from foreign investor's appetite for domestic bonds. That said, along with the potentially more accommodative monetary policy stance from now on, CNY could still be biased for more weakness against the USD into the end of the year.

- More details on the LPR: The central bank will require commercial lenders to set the price for new loans to businesses and households "mainly" with reference to the LPR, while the price for outstanding loans allowed to be retained for now. To compute the new LPR, commercial lenders will submit prices in terms of a spread on top of the interest rate of PBoC's medium-term lending operations, currently at 3.3% (TMLF rate at 3.15%).

- Following the fresh LPR, PBoC had a fresh methodology for banks to calculate the new personal mortgage loans based on the latest monthly loan prime rate. Personal mortgage loan rate for the first home must not be lower than the loan prime rate of a corresponding tenor (1y at 4.25%; 5Y at 4.85%). The rate for a second home must be at least 60bps above the LPR. We see this as a way for central bank to have a stronger influence on the mortgage rates and to improve transmission mechanism for monetary policy. We now monitor the MLF rates for any policy signals as well as the next LPR rate to be announced on 20th Sep, 9.30 am (SGT).

- **Latest Fiscal and External Balance Outlook: The** fiscal target is 2.8% of GDP in 2019. The politburo meeting that ended on 30th Jul concluded with promise of more fiscal stimulus targeted on rural rejuvenation, infrastructure projects such as carpark lots so as to boost investment and consumption at home. There is no detail on this fiscal package yet. With exports still rather soft and external headwinds, there could be further subsidies for exporters as well, especially for SMEs. Focus is on infrastructure spending as well as tax cuts in order to boost domestic demand and the Politburo reiterated "housing is for staying, not for speculation".

- **Key domestic events and issues to watch <u>for Sep</u>:** PMI-mfg (Aug) due on 31st Aug; Tariffs on estimated $116bn of Chinese goods take effect while US soybeans and crude oil are levied 5% more tariffs on 1st Sep; Caixin Mfg PMI (Aug) on 2nd Sep; Foreign Reserves (Aug) on the 7th; trade data (Aug) on 8th; Aggregate financing, M2 Money Supply and new yuan loans on 9-15th; CPI and PPI (Aug) on the 10th; FDI (Aug) on 11-18th; Urban FAI, IP and retail sales (Aug) on the 16th; new home prices (aug); FX Net Settlement (Aug) on 19th; 5Y, 1Y LPR (Sep) announcement on 20th; industrial profits (Aug) on 27th, current account balance (2Q F); NBS PMI (Sep); 70th Anniversary of the Founding of the People's Republic of China (Golden Week – National Day Holiday 1-7th Oct).

- **Technical Analysis:** There are quite a number of reasons for USDCNY to remain stable, not least of all China's 70th Founding Anniversary on 1st Oct and RMB is normally kept rather stable ahead of important events and few are as important as its own 70th National Day. So we have been of the view that 7.20 should cap the USDCNY for Sep.

However, our observation of the fixing and recent comments on "removing tariffs" by China's MOFCOM spokesperson Gao suggests that progress might be even more significant this time and we look for a potential test of the 7.10. On the daily chart below for USDCNH, we spot a bearish divergence of the USDCNH spot with the MACD forest which typically precedes a downmove, coinciding with the recent hopeful rhetoric. We look for a move below support at 7.1418 and perhaps even towards the next support at 7.0772..

KRW: Bearish But Not Ruling Out Technical Rebound

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDKRW	**1220** (--)	**1200** (1185)	**1185** (1165)	**1170** (1160)

Previous Forecasts in Parenthesis

- **Motivations for the FX View:** We retain a bearish bias on the KRW overall on a combination of factors including (1) little signs of progress on US-China trade dispute; (2) deterioration in US-Japan relations; (3) continued slowdown in global, domestic growth momentum and exports; (4) potential another growth forecast downgrade by policymakers; (5) rising risk of BoK potentially cutting policy rate again in 4Q-2020; (6) down-cycle in global semiconductor market weighing on Korean corporate profits and Korea asset prices. We also revised our forecasts higher from 4Q-2019 to reflect the recent change in our house view's base case scenario on US-China trade dispute - now looking for a trade deal to be delayed to sometime in 1H 2020. Nonetheless we see some chance of a technical recovery in the weeks ahead from a positioning point of view and given that quite a significant chunk of bad news have been priced in making KRW possibly asymmetrically more sensitive to any good news – especially on positive political development (US-China, Japan-Korea) if any, which is typically fluid (2-way risks) and/or if Fed turns more dovish than expected.

- **US-Japan Tensions Worsened.** S. Korea has started to walk the talk in retaliation to Japan removing S.Korea from its white list. It was reported on Bloomberg that South Korea will notify Japan of its decision to end military intel-sharing pact with Japan. Earlier S.Korea had also raised radiation concerns at Tokyo 2020 Olympics and the public is boycotting Japanese consumer goods and leisure travel. Worsening of relations is expected to keep the pair supported.

- **Recent Escalation in US-China Trade Tensions Reinforced that trade talks could likely be protracted.** China announced (23 Aug) additional levy of 5 – 10% on $75bn of US goods, including an additional 25% on US autos and 5% tariff on US crude oil imports while Trump retaliated by increasing tariff rate to 30% (from 25%) on the $250bn worth on

Chinese imports and to 15% (from 10%) on the remaining \$300bn of Chinese imports. Our house view no longer looks for US-China trade deal to materialise this year. Instead we see a delay towards 1H 2020 (which may well still be perceived as optimistic in terms of market expectations).

- **More Downside Risks; Slower Growth; BoK Easing Not Ruled Out.** Another 25bps cut later this year given that hopes for growth rebound in 2H are fading while inflation remains sub-1% for the 7th consecutive month. Ongoing trade spat between Japan-Korea and unresolved trade dispute between US and China are not helping with the investment, growth cycle. The next cut may come soon possibly in Oct's meeting if domestic economic activity, exports and inflation continue to show no signs of recovery.

- **But KRW Weakness is Not Bottomless.** We observed that Korea's consumer sentiment has plunged to 31-month low in Aug. Historically the correlation between Korea's consumer confidence and KRW is positive and the last time both consumer confidence and KRW declined this sharply was back in Jan-2017. But subsequently for the rest of 2017, both consumer confidence and KRW strengthened sharply amid global synchronous recovery. We are not suggesting that a recovery turn is coming but wish to highlight that should there be optimism; USDKRW could possibly be near its inflection point (i.e. room for further upside may be limited towards 1240/45 levels. Any meaningful recovery in KRW would still require material upticks in economic activity, recovery in tech sector to reverse the fortunes of Korean exports where shipments of semiconductors account for 1/5 of overall Korean exports or the easing of geopolitical tensions between Japan and South Korea.

- **Growth and Inflation Outlook: Growth outlook remains downbeat and could possibly be guided lower by authorities** in the coming weeks. For 2019, BoK and Finance Ministry expect growth to come in at 2.2% and 2.4 – 2.5%, respectively. Recent development including the deterioration in US-Japan relations as well as re-escalation in trade tensions between US and China may amplify downside risks on trade and delay the chance of a recovery that the government was looking for.

- **South Korea avoided a technical recession as 2Q growth rebounded +1.1% q/q (vs. -0.4% in 1Q).** On annual basis, 2Q GDP was +2.1% y/y (vs. 1.7% in 1Q). Public investment was the main support for growth amid government spending. Private consumption was largely stable at 2% y/y while private investment was the main drag on growth, with facilities (-7.8% y/y) and construction investment (-3.5% y/y) falling sharply. Exports remain on a decline (-11% y/y) in Jul and the trade spat with Japan over wartime labor row issues – Japan has restricted exports of three chemicals that are crucial to South Korea's major companies such as Samsung Electronics SK Hynix in the production of microchips and smartphones. Prolonged trade spat could dampen hopes for a recovery in 2H. However recently approved supplementary budget of KRW5.83tn (or S\$4.87bn) to support growth and mitigate impact of Japan's export controls could provide some support for 4Q 2019.

- **Headline inflation saw another sequential slippage to -0.3% m/m in Jul, down from -0.2% in Jun. This is the 7th consecutive month of inflation below 1% level.** BoK attributed the low inflation to weak consumption and the fall in oil prices. Core inflation inched modestly higher to +1% y/y in Jul (vs. +0.9% y/y in Jun).

- **Monetary Policy Forecast**: There is no MPC meeting scheduled in Sep. We see **rising chance of BoK cutting policy rate by 25bps to 1.25% at the upcoming MPC meeting on 16 Oct** as hopes for growth rebound in 2H are fading while inflation remains subdued below 1% for the 7th consecutive month and shows no signs of recovery. Ongoing trade spat between Japan-Korea and unresolved trade dispute between US and China are not helping with the investment, growth cycle. **The next cut could materialise in Oct's meeting if domestic economic activity, exports and inflation continue to show no signs of recovery.** Further Fed rate cut could also provide the policy space for BoK to respond.

- Following the 25cut at the 18 Jul MPC meeting, the BoK kept policy rate on hold at 1.5%, as expected at the last MPC meeting (30 Aug). Decision was not unanimous as 2 members called for rate cut. Accompanying statement noted that uncertainties over its growth and inflation forecasts had increased and will judge whether to adjust the degree of monetary policy accommodation. BoK Governor Lee highlighted a number of geopolitical risks in addition to ongoing tensions between Japan and Korea, US-China trade dispute, Italy political uncertainty and Brexit, etc. He added there is some room in monetary policy to respond to economic situations in necessary but also cautioned against lowering interest rate too low in light of the accumulation in domestic debt.

- **External Balance Outlook:** Current account surplus rose to 8-month high of $6.38bn in Jun thanks to goods account surplus and record high returns from foreign investments. Services deficit rose to $2.1bn, from $1.16bn but the print still shows an improvement from $2.4bn on a year on year basis.

- **Key domestic events and issues to watch:** S. Korea releases Aug exports (1 Sep); Aug PMI mfg (2 Sep); 2Q final GDP, Aug CPI (3 Sep); Aug FX reserves (4 Sep); Aug unemployment rate (11 Sep), export/import prices (18 Sep); Aug PPI (24 Sep); Sep consumer confidence (26 Sep); Aug Industrial production (30 Sep).

- **Technical Outlook:** USDKRW broke up to the upside for the month of Aug. But rally found interim resistance around 1222. Pair subsequently consolidated in the 1200 – 1220 range of a large part of Aug. Last seen at 1210 levels. Bullish momentum on weekly chart remains intact but shows tentative signs of fading while stochastics is rising into overbought conditions. Elsewhere a potential bearish divergence could be in the making, as seen on weekly MACD. Taken together near term upside risks towards 1240/45 levels not ruled out but bias to sell rallies as we look for a move towards 1180/85 levels.

SGD: Trade War Woes, But Haven Characteristics Mitigate

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDSGD	1.4000 (1.3850)	1.3950 (1.3750)	1.3900 (1.3700)	1.3800 (1.3650)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Forecasts are adjusted upwards from last month due to higher level of structural trade tensions in the global economy. With trade exposure at more than 3-times GDP and a significant share of high-tech manufacturing in economic output, Singapore is relatively vulnerable to (i) a decline in intermediate goods exports to China, (ii) re-configuration in regional supply chains, (iii) broad slowdown in external demand amid rising protectionism, all of which are likely to persist for some time amid the re-escalation in trade tensions between US and China. Notably, the USDSGD pair has already risen by around 1.5% since the turn of the month, post Trump's announcement of new tariffs, and like other trade-dependent AxJs, the SGD is likely to remain on the backfoot for a while. Continued weak growth momentum and tame inflation is also increasing the likelihood of a MAS easing in Oct, potentially to neutral slope. Using historical performance as a guide, we see more room for SGD NEER to decline. Nonetheless, the extent of weakness could be capped, due in part to partial regional safe haven characteristics of SGD sovereign bonds.

- Our base case has been adjusted—the twists and turns surrounding the trade tariff rhetoric, and the current low level of trust between two parties imply that the time taken to reach a deal, if at all, will likely be much longer. While lines of communications could remain open, potential concretization of positive details might not occur until the first few quarters of 2020, when Trump can leverage on the political capital from completing such a feat heading into the new US elections cycle. Signs of reprieve or a dial-back in trade tensions (even if not a complete unwinding of existing tariffs), could lead the SGD to see more relief then.

- A recent report by our Economists showed that the ongoing trade conflict produced winners and losers among the AxJs. (See piece here.) Notably, Vietnam was a clear winner from the trade diversion from US tariffs on China, while Malaysia was a winner from China tariffs on US. CLM and Thailand were seen benefiting to lesser extents as well. On the other hand, Singapore did not see any significant gains from trade diversion flows. Given that Singapore-based electronics manufacturers account for around 11% of global market share for the semiconductor wafer foundry output, and that nearly 10% of Singapore's GDP is attributable to exports to China (both final and intermediate demand), the economy is likely to remain vulnerable to the current external environment.

- In particular, any delay in the tech cycle recovery, especially in an environment of slowing Chinese demand, ongoing Japan-Korea trade spat, and where companies globally are reluctant to commit to spending on capital goods, will continue to drag on Singapore's growth. Global semiconductor sales had slumped more than 13%y/y in 1H 2019, the sharpest decline since 2009. Concomitantly, double-digit contraction continued to be observed in July NODX (-11.2%y/y vs. -17.3% prior) and electronics exports (-24.2%y/y vs -31.9% prior), even as there's signs that the pace of decline is slowing. Notably, US firms with a presence in Singapore such as Broadcom, Intel and Micron, could also potentially see negative impact from US export controls going forward. Negativities in the growth outlook support our call for authorities to ease in Oct, with a potential shift to neutral slope for the SGD NEER (from current estimated 1.0%), which is consistent with an upward bias for USDSGD.

- Nonetheless, the extent of weakness could be capped, due in part to partial regional safe haven characteristics of SGD sovereign bonds. Sg sovereign bonds pay the highest returns currently among economies that have AAA credit ratings from all three major rating agencies. Auction for S$2.9bn of 10Y notes (significantly larger than historical average) conducted recently drew a decent bid-cover ratio of 1.89 (compared to 1.83 prior). Cut-off yield was 1.69%.

- **Growth and Inflation Outlook:** Final 2Q GDP figures came in relatively unchanged from advanced figures, i.e., -3.3%qoq saar and 0.1%y/y (vs. -3.4%qoq saar and 0.1%y/y in advanced release). Manufacturing contracted (-3.1%y/y) while services rose at the slowest pace since the global financial crisis (+1.1%y/y). Construction growth, while positive, was also relatively modest at +2.9%. The initial sharp downside surprise during the advance release had led most economists to revise downwards their full-year growth estimates, with some noting that the likelihood of a technical recession in 3Q has also increased. At the release of the final 2Q figures, MTI downgraded full-year GDP growth estimate sharply to 0%-1%, from 1.5% to 2.5% previously. This inherently factors in potential for a technical recession (i.e., two quarters of negative sequential growth) in 3Q.

- Taking into account the escalating US-China trade war, Japan-Korea trade spat, and potential spillovers in sentiments from the Hong Kong crisis, our economists have downgraded their GDP growth forecast to 0.6% in 2019 (from 1.1% previously) and 1.6% in 2020 (from 2.1% previously). Despite positive surprises in July PMI (49.8 vs. 49.6 expected) and IP (-0.4%y/y vs. -5.8% expected), it could be premature to call for a growth recovery, as improvements could in part reflect frontloading on expectations of further trade tension escalations. A larger proportion of the subsequent US tariff wave (in Sep and Dec) will be on consumer goods (about 40%), especially electronics, versus the first wave (about 20%), and this could result in continued softness in external demand for Singapore's manufacturing output.

- Some roll-out of stimulus measures to support SMEs, especially those in manufacturing and trade-related services, might take place as the downturn worsens. While sectors such as ICT, construction, health &

education can potentially impart some resilience to the economy, they are unlikely to fully offset drags from externally-oriented sectors.

- On the inflation front, Core Inflation fell to a near 3-year low of +0.8% in July, from +1.2% in Jun, due to continued soft services inflation, falling prices of retail & other goods (water supply), and a steeper decline in the costs of electricity & gas tariffs. Headline CPI rose by a mild +0.4%y/y in Jul (from +0.6% in Jun) due largely to the same factors, as well as muted private road transport costs (+0.3%y/y vs. +0.2% in June). MAS has tweaked its core inflation outlook, expecting core inflation to come in within the lower half (vs. previous "near the mid-point") of its 1% to 2% forecast range. Headline inflation forecast range of 0.5% to 1.5% is kept unchanged. Our Economist's estimates for Core and Headline Inflation are at +1.2% and +0.7% for 2019, respectively, as demand conditions remain muted.

- **Monetary Policy Forecast**: After tightening monetary policy at both of its semi-annual policy meeting last year, the MAS affirmed a pause in its policy normalization process in April as growth eased and inflationary pressures remain mild. Its policy of a "slight appreciation bias" for the SGD NEER was maintained, with the slope of the SGD NEER policy band still assumed at 1.0% (house estimate). The pause came as the MAS turned more cautious given the uncertainties in the global environment, cautioning in its statement that "significant uncertainty remains over the short-term outlook". This was largely warranted, as trade tensions flared up shortly after in May, global growth remained soft, and domestic growth indicators tanked. Notably, US also added Singapore to a monitoring list for currency manipulation in its US Treasury report end-May. This was largely a non-event in FX impact for the SGD, with the MAS coming out to clarify the role of the exchange rate as a monetary policy tool for Singapore.

- Our Taylor Rule estimates for the SGD NEER highlight that an appropriate SGD NEER slope consistent with current growth and inflation projections could be in the -0.5 to +0.5% range; the extent of appreciation has come down significantly given the recent downward revisions in growth and inflation. Given increased likelihood of technical recession in 3Q and continued benign inflation, there is an **increased probability that the MAS could ease at its next policy meeting in Oct,** compared to conditions three months ago.

- As at writing, USDSGD is around 1.3890, and trades around 0.7% above the implied mid-point of 1.3990, with the top estimated at 1.3710 and the floor at 1.4270. While having come off quite a fair bit since the end of June (from 1.8% above mid-point then), SGD NEER remains in the upper half of the band. Our earlier note on SGD NEER (see here) makes the case for a potential easing to neutral slope, with SGD NEER potentially declining to the mid-point of the policy band, or even slightly below. A risk to this view is a sharp decline in USD strength at some point, which could mitigate the extent of weakness in SGD NEER.

- Domestic interest rates have continued to trend downwards from the highs in May. The 3-month SOR (3MSOR) and 3-month SIBOR (3MSIBOR) are at 1.73658% and 1.87933% respectively at the time of writing, lower than the 1.75771% and 1.99758% recorded at end-July. With

Fed's dovish tilt likely intact with the re-escalations in trade policy uncertainty, there could be downward pressure on rates going forward, although the extent of decline could be mitigated by expectations of a smaller appreciation (or even flattening of slope) in the SGD vis-à-vis the USD. Deposit rates (for 12-month fixed) was unchanged at around 0.57% (last data point at end-July). The interest rate easing bias should help mitigate financial stability risks in interest-sensitive sectors (e.g., property) for now. We expect the 3MSOR and 3MSIBOR to decline to around 1.60% and 1.76% respectively by end-4Q 2019.

- **Latest Fiscal and External Balance Outlook:** The FY2019 budget is modestly expansionary, with the primary deficit projected at SGD5.4bn (1.1% of GDP). Authorities estimate a fiscal impulse of around +0.7%, providing an appropriate boost to the economy given presence of external headwinds. This comes on the back of an increase in projected expenditure of SGD1.3bn to SGD80.3bn, and an increase in operating revenue of SGD1.2bn to SGD74.9bn. The overall deficit is pencilled to come in at SGD3.5bn (0.7% of GDP) due to the record-high special transfers of SGD15.3bn in the FY2019 budget (FY2018: SGD9bn). With sentiments relatively soft on the ground, DPM Heng Swee Keat had assuaged sentiments on the ground by clarifying that "a full-year recession" for the economy was not expected at this point, and that stimulus measures were ready in the event of any sharp downturn in external conditions.

- Details are scant for now, but gauging from the mix of policies in the 2009 Resilience Package, the focus could likely be on helping workers keep their jobs via wage credits (subsidies to corporates' wage bills), skills upgrading, and income supplements for low-wage earners. Corporate and personal income tax rebates would likely come into the mix too. These measures might be needed to mitigate drags in the labour market, as firms cut back on workers and hiring in the months ahead. There might also be a focus on supporting SMEs, especially those in manufacturing and trade-related services.

- The current account (CA) surplus remained at healthy levels, dipping very slightly to SGD21.5bn in 2Q, from SGD$21.6bn in 1Q. As a percentage of GDP, the CA surplus was at 17.34% in 2Q 2019 vs. 17.99% in 1Q. Compared with 1Q, the services balance deteriorated slightly on higher imports of transport and travel services, while the goods balanced actually recovered on higher exports. Nonetheless, the goods exports level still saw a contraction on a year-ago basis (around -1%y/y). The continued impact of the US-China trade tensions on Singapore's trade balance outlook will continue to be of some concern, although the structurally higher level of current account surpluses should still assure international investors of the country's long-term resilience.

- **Key domestic events and issues to watch**: Aug PMI (3 Sep); Aug Foreign Reserves (6 to 9 Sep); Jul Retail Sales (12 Sep); Aug Exports (17 Sep); Aug CPI (23 Sep); Aug IP (26 Sep).

- **Technical Outlook**: USDSGD largely trended up for the first half of Aug, and have been trading largely between 1.3825 and 1.3910 for the past two weeks. Last seen at 1.3890. Daily charts indicate a modest bearish momentum, while stochastics are slowly heading towards near-overbought conditions. We note that 1.3870-1.3900 is a strong support/resistance region, and it could take persistent gains above 1.3900 for the pair to head further upwards. Nearby support at 1.3870, then 1.3810 (23.6% fibo retracement from Jul low to Aug high), then 1.3750 (38.2% fibo). Next resistance around 1.3940.

MYR: Still Weighed by Global Trade Underperformance

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDMYR	4.2500 (4.1600)	4.2500 (4.1400)	4.2200 (4.1300)	4.1800 (4.1200)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** The MYR reached a high of 4.2280 on 29 Aug as the USD strengthened amid escalation of US-China trade war concerns in Aug. We are still looking for mild USD strength against the Asian currencies to continue into end 3Q and early 4Q now. For 2H 2019, we see regional central banks likely to still stay accommodative although threat from global trade underperformance has kept MYR soft. Similar to other regional currencies, the MYR still faces pressure as it faces external downside risk from US-China trade situation with mitigation from stimulus to domestic demand from existing and potential monetary policy easing, but it could see resilience via the sentiment channel from resumption in major infrastructure projects and Government development spending, as well as evidence of Malaysia benefiting from some trade diversion.

- The latest Trump tariff announcement and latest China retaliation could worsen global sentiment and growth concerns may emerge, and as such raise likelihood of a Fed cut in Sep and in the last few months this year. Our economics team is looking at a baseline of 100bps (including 25bps cut already delivered) up to 1H 2020 and it looks unlikely that the Fed will cut rates close to the US Presidential election amid moderating growth. The market is pricing in 81/117bps cut next 6 months/2 years somewhat in line with my tentative 100bps cuts view up to 1H 2020 mentioned above.

- **The resumption of US-China trade talks including any potential positive outcomes, signs of positive news from FTSE Russell in their Sep 2019 decision on Malaysia bonds in the WGBI, or further investment inflows into Malaysia and MYR-denominated assets could support the MYR. (FTSE Russell Decision expected on 27th Sep)** A reversion back to risk-on mood at times, low vol environment amid central banks on easy monetary policies could still see carry plays outperform at the expense of lower yielders such as JPY. Into the end of the year, our base grey-swan scenario is still that of a protracted period of negotiation with “lines of communication” remaining open. Progression on talks taking both sides closer to a deal probably in 1H 2020 is not impossible and this could help support sentiment and support our view for trade/tech-linked FX to recover. But the risk of escalation remains.

- However, in the emerging markets space, we could see a sustained rally in emerging-market bonds as EM central banks may continue to embark on a rate-cutting cycle to support growth. Even though, the Fed has eased to "insure against downside risks" but did not signal the start of a lengthy easing cycle, we acknowledge that the market has moved very quickly to pricing in rather dovish outcomes for the Fed. As such we are not aggressive on all EM currencies except for Indonesia within the region, given its carry allure under current environment. The level of vulnerabilities in aggregate across EM are relatively controlled and contained for now. However there is the risk of the lingering U.S.-China trade tensions and it worsening, curbing appetite for riskier assets. If the EM inflows intensify, we could see some of it cascading into the MYR assets. Our Malaysia economics team do not rule out another 25bps OPR cut in 2019 (Sep onwards) if downside risk to growth from the trade tension persist and/or worsens, considering that the recent OPR cut was "event-driven" in reaction to the negative development on US-China trade situation. At the same time, we do not see BNM making any move until up to Sep 2019, pending announcement by FTSE Russell on Malaysia's status in the World Government Bond Index (WGBI). The downside of a non-inclusion is not priced in at the moment.

- We expect market participants will start to focus again on the Fed rate cuts around Sep and Dec even as the Fed's target measure of inflation remains well below the 2% level. We have generally revised the USDMYR higher to reflect our further concerns on global growth, the recent intensified tariff increases from US and China and the still unclear Fed wait-and-see stance. Against this backdrop of weaker global growth, rising uncertainty on the trade tariff exchanges over the next 6 months even if the Fed eases in Sep, we should on average still see mild USD strength against the regional currencies to remain entrenched subject to no interventions by the Trump administration. USDMYR is expected to end around 4.25 in 3Q19 and end the year at 4.25 to the USD.

- We still expect crude oil and palm oil prices to remain range bound over the next few months and should have limited impact on the MYR. Fundamentally, we think the picture for risk assets including EM FX such as MYR remains quite bright if global growth sees some sustained green shoots amid extended easy monetary policy, provided markets and policymakers manage to navigate near-term risk events such as Brexit and US-China trade and tech wars. But these could likely pan out more in the middle of 2020.

- External reserves dropped – USD0.8b to USD103.1b as at mid-Aug 2019 (end-Jul 2019: USD103.9b) despite mixed indication on portfolio capital flows i.e. foreign selling in equities but larger foreign buying in bonds, suggesting a factor that could explains reserves' drop is the continued unwinding of – or sizeable maturity in – BNM's net short FX positions.

- Foreign investors were net sellers of Malaysian equities so far this month (1-21 Aug 2019) totaling –MYR2.2b (Jul 2019: -MYR0.1b). In contrast, there is indication of net foreign buying of Malaysian bonds this month sustaining the net buys in Jun-July 2019, taking cue from the drop in 10- year Malaysian Government Securities (MGS) yield to this year's low of 3.22% on 16 Aug 2019 – and the lowest since 3.06% on 14 May 2013 - vs 3.59% end of July 2019.

- Few factors may well account for this. The outlook of chronic low/negative yields in Developed Markets is positive for higher-yielding investment-grade bonds in the Emerging Market, including Malaysia. This may also led to FTSE Russell potentially keeping Malaysia in World Government Bond Index (WGBI) in its review next month, on top of measures announced by BNM to enhance onshore FX and bond markets accessibility and liquidity (see next page). Market is also pricing in another OPR cut by BNM after the 25bps cut in May 2019. We expect BNM to stand pat at the coming 11-12 Sep 2019 MPC meeting, but not ruling out 25bps cut in OPR at the 4-5 Nov 2019 MPC meeting.

- However, despite the magnitude of foreign net flows in the bond market being consistently larger than that in the equity market over the past three years, thus implying net foreign bond buying outsizing net foreign equity selling this month, the drop in external reserves in 1H Aug 2019 suggests another factor is at play. And we suspect it could be the continued unwinding of – or sizeable maturity within - BNM's net short FX positions, of which latest figure is USD14.7b as at June 2019, down from USD15.7b in May 2019. Recall also in Mar 2019, external reserves rose by just +USD0.6b despite inflows from the Government's JPY200b (USD1.8b) Samurai bond issuance amid small +USD0.3b net foreign buy of Malaysian equities and bonds, as this was offset by the USD3.6b drop in BNM's net short FX positions in the month that was largely due to positions maturity.

- Malaysia's latest external reserves figure of USD103.1b is equivalent to 7.6 months of retained imports and 1.1x total short-term external debt. It is also 5.9% above the estimated minimum required reserves of USD97.4b under IMF's Assessment of Reserve Adequacy (ARA) framework. Furthermore, the official external reserve is not the only means for private sector - banks and corporations - to meet their external obligations as Malaysia has sizeable external assets outside the official external reserves. As at end-2Q 2019, banks and corporations held MYR1.35tr or three quarter of Malaysia's MYR1.8t external assets, which is more than enough to cover their MYR728.3b external liabilities.

- **Growth and Inflation Outlook:** 2Q 2019 real GDP picked up to +4.9% YoY (1Q 2019: +4.5% YoY), in line with our +4.8% YoY estimate.

- Maintain full-year forecasts of +4.4% as we stay "cautiously constructive" on macro outlook that mainly reflects external downside risk from US-China trade situation vs mitigation from stimulus to domestic demand via monetary policy easing and resumption in major infrastructure projects and Government development spending, as well as evidence of Malaysia benefiting from some trade diversion. The full-year growth forecast implies 2H 2019 growth of around +4.2%% vs +4.7% expansion in 1H 2019. Official 2019 growth forecast remained at 4.3%-4.8%. Budget 2020 to be tabled in the Parliament on 11 Oct 2019 will provide update to 2019 growth forecast – if any – as well as the first official growth forecast for 2020. We currently expect next year's growth to be at +4.4%.

- On the supply side, growth benefited from mining rebound and manufacturing resilience amid slower services and agriculture, and flattish construction. On the demand side, domestic demand picked up on private expenditure growth as public spending slumped, on top of faster net external demand growth albeit due to import compression amid stagnant export.

- Staying "cautiously constructive", our economics team maintained its 2019 growth forecast of +4.4% (2018: +4.7%). We remained "cautiously constructive" on macro outlook as highlighted in our 2H 2019 Outlook and Lookout published on 2 July 2019 (2H 2019 Outlook and Lookout_MKE_20190702.pdf). The theme mainly reflects external downside risk from US-China trade situation vs mitigation from stimulus to domestic demand from monetary policy easing and resumption in major infrastructure projects and Government development spending, as well as evidence of Malaysia benefiting from some trade diversion.

- Resilient growth year-to-date (1H 2019: +4.7%; 2018: +4.7%), MYR volatility, fluid US-China trade situation, FTSE Russell announcement on Malaysia status in its World Government Bond Index (WGBI) next month, and Budget 2020 on 11 Oct 2019 may prompt BNM to stand pat at 11-12 Sep 2019 MPC.

- The importance of the upcoming "FTSE Russell event" is reflected by the progress update on measures to boost FX and bond markets' liquidity announced in May 2019, and additional liberalisation of Foreign Exchange Administration (FEA) measures effective 30 Aug 2019 (MKE Fixed Income Research_BNM Measures to Enhance Markets_20190816). Apart from what BNM described as constructive and positive engagements with FTSE Russell, we also understand there will be engagements with foreign bond investors in 2H Aug 2019 to explain measures to improve market access and liquidity.

- However, we are not ruling out another 25bps cut in OPR at the 4-5 Nov 2019 MPC, especially if US-China trade tension persists or worsens, in turn adversely affecting economic outlook going into 2020. The uneasy US-China "Trade Truce & Talks 2.0" and the danger of a broader global trade conflict underscores the downside risk on global and domestic growth outlook, which is a key factor in BNM's monetary policy decision.

- **Monetary Policy Forecast:** BNM cut Overnight Policy Rate (OPR) by 25bps to 3.00% after its Monetary Policy Committee (MPC) meeting on 6-7 May 2019. To note, BNM has been "ahead of the curve" in normalizing its Overnight Policy Rate (OPR) post-GFC, with the gradual OPR hikes from the record low of 2.00% since Mar 2010 to the post-GFC high of 3.25% in July 2014, which was 25bps below the pre-

GFC peak of 3.50%. Thanks to this, BNM consequently has the room to cut OPR.

- A 25bps OPR cut can boost real private consumption growth by as much as 0.3ppt. Our economics team estimated that on an annual basis, a 25bps OPR cut entails MYR1.4b savings on mortgage repayments that can boost real private consumption growth by 0.3ppt based on consumer spending multiplier of 1.5x.

- The room for monetary policy to be supportive of growth is also afforded by the benign inflation, which we now expect to average +1.0% in 2019 (1H 2019: +0.2%; 2018: +1.0%) and +2.1% in 2020.

- We expect BNM to stand pat at 11-12 Sep 2019 Monetary Policy Committee (MPC) meeting amid resilient growth year-to-date (1H 2019: +4.7%; 2018: +4.7%), MYR volatility, fluid US-China trade situation, FTSE Russell announcement on Malaysia status in its World Government Bond Index (WGBI) next month, and Budget 2020 on 11 Oct 2019.

- The importance of the upcoming "FTSE Russell event" is reflected by the progress update on measures to boost FX and bond markets' liquidity announced in May 2019, and additional liberalisation of Foreign Exchange Administration (FEA) measures effective 30 Aug 2019 (MKE Fixed Income Research_BNM Measures to Enhance Markets_20190816). Apart from what BNM described as constructive and positive engagements with FTSE Russell, we also understand there will be engagements with foreign bond investors in 2H Aug 2019 to explain measures to improve market access and liquidity.

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- **Latest Fiscal and External Balance Outlook**: Aside from the headwinds from external uncertainties, businesses are also awaiting clarity on domestic policy changes post-GE14, particularly reviews of tax systems and 130 investment incentives under 32 approving authorities as stated in Budget 2019 Speech in 2 Nov 2019, which could be announced in Budget 2020 to be tabled on 11 Oct 2019.

- Fiscal consolidation on track via implementation of Budget 2019's revenues and expenditure measures. The Government aims to lower its budget deficit to MYR52.1b or 3.4% of GDP in 2019 vs MYR53.4 or 3.7% of GDP. Indicating fiscal consolidation is on track, as at Jan-May 2019, the budget deficit was MYR21.4b, down from MYR35.1b in Jan-May 2018 and 41% of the full-year 2019 target.

- Rebound in Federal Government's development spending, on top of the continuation and revival of major infrastructure projects. Federal Government net development expenditure (NDE) jumped +18.2% YoY to MYR23.4b in 1H 2019 (1H 2018: -0.7% YoY; 2018: +28.5%) to account for 43% of Budget 2019's NDE allocation, up from MYR9.8b in 1H 2018 that was 36% of total actual NDE in 2018. At the same time, construction activities – which has the highest output multiplier effect on the economy - will be also be revitalised with the continuation and revival of major infrastructure projects that were previously put under review or deferred following the change in government after the 14th general election in May 2018.

- Crude oil price's year-to-date average of USD66/bbl sits well within the Government's medium-term fiscal framework assumption of USD60-70/bbl that also underpins the target to lower budget deficit further to 3.0% of GDP in 2020 and 2.8% of GDP in 2021.

- **Key domestic events and issues to watch:** FX reserves (6 & 20 Sep); Trade Balance (4 Sep), Ind Production (11 Sep), CPI (25 Sep), BNM Monetary Policy Statement (12 Sep).

- **Technical Outlook:** USDMYR rose sharply above 4.20-handle for the month of Aug. Last seen at 4.2180 levels. Bullish momentum on weekly chart remains intact. Risks remain skewed to the upside. Next resistance at 4.2540 levels (61.8% fibo retracement of 2017 high to 2018 low). Support at 4.20, 4.1780 (50% fibo).

IDR: Cautious Optimism In Portfolio & Infrastructure Flows

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDIDR	14200 (14000)	14200 (13950)	14100 (13900)	14050 (13850)

Previous Forecast in Parenthesis.

- **Motivation for the FX View:** Forecasts are adjusted higher for the USDIDR pair (i.e., weaker IDR), on tweaks to our base case scenario that now incorporates a much lower likelihood of a deal between the Trump and Xi administrations being reached by year-end. The USDIDR pair had seen a sharp step-up in early Aug (~from 14070 to recent high of 14360), as trade tensions escalated once again between US and China. Most of the two-way swings seen this month were also due in part to new tariff-related announcements (easing/retaliation). Going forward though, we look for some relative stability in IDR, as BI has shown its determination in calming markets when needed. Indonesia, with GDP growth expected at above 5%, could also be seen as a (relative) outperformer in Asia, even as fiscal and current account twin deficits continue to be of concern given the current soft external outlook. In a returns-hungry world, potential portfolio, FDI or infrastructure-related flows aimed at longer-term returns could be a supporting factor for IDR's medium-term outlook as well.

- We note that MTD net outflows from Indonesian equities and government bonds stand at US$656mn (as at 29 Aug) and US$281mn (as at 26 Aug). This was a drastic change from the US$20mn net outflow in equities and US$1.7bn net inflow in government bonds in Jul. We had cautioned last month that "with the increase in perceived trade tensions globally, there might be some unwinding of EM carry trades in the very short run", and this seems to be playing out, although to a greater extent than expected. Nonetheless, even with BI's recent 25bps policy rate cut from 5.75% to 5.5%, current ten-year government bond yields are still above 7%. Further rate cuts are still on the table, but resilient growth (above 5.0%) could mean that any upcoming rate cuts would also likely be relatively modest in magnitude, compared to the six hikes last year. With inflation remaining tame, real yields are likely to remain attractive to foreign flows, especially when other global central banks are similarly in easing modes. We think there is a fair chance that bond inflows could be net positive for the whole of 2H, even if monthly flow levels are more modest compared to highs in June. Concerns over debt levels are also likely manageable, given that Indonesia's overall debt-to-GDP ratio of around 30% is significantly below levels during the global financial crisis or Asian financial crisis.

- Another potentially significant driver of inflows could be longer-term FDI and infrastructure investments. New FDI in Indonesia was at a record high of US$29.3bn last year, spread over nearly 22,000 projects, while the figure in 1H this year shows promise at US$14.2bn. Singapore and Japan are top investors. We note that Indonesia's rank in the World Bank's Ease of Doing Business Index has jumped from 110th to 72nd position over the last three years, and President Jokowi is targeting rank 40 by 2024. We note that his "I have nothing to lose" attitude amid his announcement of sweeping reforms on 12 Jul, could serve to accelerate such flows. Reforms include lowered corporate tax rates (to 20% from 25%), easing of stringent labor laws and lifting of curbs on foreign ownership in more industries, including petrochemicals and other manufacturing industries. Bank merger rules are also set to be relaxed to boost FDI.

- Due in part to its archipelagic nature, infrastructure needs in the country are massive, comprising of highways, toll roads, sea ports, airports, mass transit, telecommunications and power generation, and some estimates place the required investment at as high as US$500bn per annum. Besides partnerships with programs such as China's Belt & Road Initiative and Japan's Partnership for Quality Infrastructure, various domestic projects will also likely tap on funds and expertise from the multilateral development banks, i.e., World Bank, Asian Development Bank, and most recently the China-led Asian Infrastructure Investment Bank. In his latest Budget Speech, Widodo unveiled a record IDR2,528.8trn (~US$178bn) in projected public spending in 2020, out of which approximately IDR419.2trn is earmarked for infrastructure projects (up from IDR399.7tn this year). Projects include 837km of roads, 239km of rail lines, and three new airports.

- Examples abound of public-private partnerships in the domestic infrastructure scene. Fee-charging motorways on Java are looking to Hong Kong investors for funding, while deals were signed with UAE recently to develop projects including the Balikapapan refinery, an integrated supply chain and LNG storage. Maspion and DP world also jointly invested US$1.2bn to develop a container port in Gresik East Java. Meanwhile, Softbank is reported to invest US$2bn through Grab over 5 years to accelerate the development of Indonesia's digital infrastructure, including an electric vehicle ecosystem.

- Despite the host of factors supporting the IDR (i.e., weighing on USDIDR pair), there is still a significant upside risk for the pair. This could come about on higher volatility in the midst of US-China trade talks, which has already seen multiple U-turns. The almost 500 pips spike at the start of Aug, while short-lived, likely put an interim dent in investor confidence. BI's commitment to IDR stability, via intervention when needed, will need to hold for foreign market players to trust Indonesian assets again. To this end, Indonesia's level of foreign exchange reserves (currently around US$118bn) will be closely watched. A second risk factor would be the potential removal of Indonesia's Generalized System of Preferences (GSP) privileges, a US trade program which allows tariff-reduced imports from certain US trade partners. Indonesia's eligibility status is currently under review, as a wide array of Indonesian trade barriers was deemed to have created serious negative effects on US commerce, including significant concerns on IP protection. Around US$2.1bn worth of Indonesian exports (1.2% of total exports) are covered under the GSP, including rubber tires, jewelry and chemicals.

- **Growth and Inflation Outlook:** After growth of 5.07%y/y in 1Q, 2Q growth came in slightly lower at 5.05%. Resilient domestic spending had helped to offset a slump in exports. Government consumption grew 8.23%y/y, while household expenditures rose 5.17% (fastest pace since Mar 2014). Private investment growth also came in at 5.01%, down slightly from 5.14% in 1Q. Exports, on the other hand, fell 1.81%y/y, with exports of oil & gas products down 31%. Ongoing trade tensions could continue to pressure world trade volume and undermine global economic growth. In 2H19, our Economists believe that investment will be the new growth engine due to political stability, more business-friendly regulations and lower interest rates. If external demand conditions worsen significantly, the government will likely boost spending and "reactivate" measures used during the global financial crisis, which would imply a widening of the budget deficit and more judicious use of tax relief. BI expects full-year growth for 2019 to come in slightly below the mid-point of the 5.0-5.4% official growth range. 2020 growth target in Budget 2020 is 5.3%.

- Headline inflation increased slightly to 3.32%y/y in July (vs. 3.28% in June), largely due to lower gold jewellery and school fees, which could be a one-off event. Core inflation grew less by 3.18%y/y, slightly less than 3.25% in June, due to softer housing, healthcare and processed food prices. We note that weather forecasts are predicting a drought in the short term, which could drive up prices of agricultural products. Nonetheless, despite the recent rate cuts (total 50bps), effects of the previous 175bps rate hikes by BI should continue to cap price pressures. Without volatile energy prices, our Economists expect full-year inflation to be manageable and to come in within the central bank's 2.5% to 4.5% official range.

- **Monetary Policy Forecast:** In the recent Monetary Policy meeting on 22th Aug, BI had surprised markets by lowering the BI 7-day Reverse Repo Rate, Deposit Facility and Lending Facilities, by 25bps each, to 5.50%, 4.75% and 6.25% respectively. This signaled that BI had shifted its policy stance to one which is more pre-emptive in supporting growth, and suggests a willingness to cut rates more aggressively. Easing slants by other central banks could still keep interest rate differentials favorable for Indonesia despite these cuts. There is also a need to keep the stimulus momentum intact, in coordination with increased government spending as seen in the recent Budget 2020 announcements. Our Economists now expect two more cuts in the Repo Rate till year end, from 5.5% to 5%. We note that the BI has been relatively committed in cooling any sell-offs in IDR bonds and currencies by intervening in the NDF market. This commitment to anchor IDR stability should help calm markets and ease volatility as well.

- **Latest Fiscal and External Balance Outlook:** The budget deficit for Indonesia came in at 0.84% of GDP for 1H due to continued external demand pressures. State revenues rose 7.8% y/y to IDR898.8tn in 1H, equivalent to 41.5% of budget, with taxation revenues accounting for IDR688.9tn. State expenditure similarly increased by +9.6% y/y over the period to IDR1034.5tn. This led to a primary balance deficit of IDR1tn in 1H2019, compared to a deficit of IDR10tn in the same period last year. Finance Minister Mulyani cautioned that realization of oil prices and oil & gas lifting which is lower than first semester assumptions will also weigh on state revenues. For the year as a whole, the government will try to keep budget deficit as targeted at 1.84% of GDP, or smaller than previous year's deficit target of 2.19% of GDP, which should be sufficiently supportive of growth.

- For Budget 2020, the target fiscal deficit is actually lowered to 1.76% of GDP, despite record government spending (IDR2,528.8tn or US$178bn). It seems to suggest more effective tax collection, as well as some prudence on the government's part, in saving some fiscal policy space should external demand conditions turn ugly. The Budget also saw relatively higher allocations for economic and social protection measures, to guard against drags from the current export downturn. While tax rates were unchanged (for now), various subsidies in income tax, VAT, and customs & excise duties were proposed.

- Indonesia's trade balance came in better-than-expected in July (-US$64mn vs. expected -$420mn), mainly to a lower deficit in the oil & gas sector. A large drop in oil imports could imply that the ongoing initiative of substituting oil with other energy sources (i.e., B20 programme; mandatory use of diesel containing 20% locally-produced biofuel) is having some positive impact in helping to rein in the current account deficit. Non-oil & gas exports contracted further by -6.9%y/y from -2.2% in June, largely due to a contraction in the exports of coal and crude palm oil, which is partially offset by increased exports of electronics. On balance, any moderation in trade tensions could take some time to play out, especially with Trump's latest announcements, and 2H is unlikely to see a significant recovery in trade growth. Current account could remain at around -2.5% to -3% deficit in 3Q and 4Q this year.

- **Key domestic events and issues to watch**: Aug Mfg PMI (2 Sep); Aug CPI (2 Sep); Aug Foreign Reserves (6 Sep); Aug Local Auto Sales (13-23 Sep); Aug Trade (16 Sep); Monetary Policy Decision (19 Sep).

- **Technical Outlook:** Pair last seen at 14200. On daily charts for USDIDR, momentum indicators are largely neutral, while stochastics indicators are heading towards near-oversold conditions. The 21 DMA has just cut the 100 DMA to the upside late last week, a tentatively bullish indicator. These factors support a mild bullish bias upwards, perhaps towards 14240/50 (21 DMA, 200 DMA). Support at 14120 (50% Fibonacci retracement from Jul low to Aug high), then 14060 (61.8% fibo). Resistance further out at 14360 (Aug high).

PHP: Temporary Weakness, Constructive Bias into 2020

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDPHP	52.50 (51.50)	52.50 (51.30)	52.00 (51.20)	51.50 (51.20)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Forecasts are revised broadly upwards amid a heightened state of global trade tensions. While a lower level of trade exposure could shield it a tad amongst AxJ FX in a scenario of further trade disruption, it is unlikely to escape completely unscathed. Export growth has remained soft this year, albeit showing signs of improvement in recent months. Despite the higher risks, upsides in USDPHP (i.e., further weakening in PHP) are likely to be capped. In addition to its lower trade dependence, other factors include (i) relatively attractive, higher-yielding sovereign bonds (behind Indonesia and India) in a falling rates environment, soft growth and subdued inflation environment; (ii) synchronous global easing including a dovish Fed providing support for easy financial conditions, supporting sentiment; (iii) more Fed rate cuts could limit USD upside; and (iv) Philippines' current account deficit is showing improvement over time, and is investment-driven, which could be looked on more favourably by markets. We look for a slow recovery in PHP strength into 2020, as global trade policy could possibly see some clarity then, particularly as US officials have repeated several times that a deal might be possible before US elections in 4Q 2020.

- While AxJs might remain on the backfoot in the interim, we note that Philippines' lower level of trade exposure compared to Korea, Malaysia, Singapore, could impart it some resilience against wild swings in sentiments, relative to trade-related currencies. Philippines' export-to-GDP ratio was around 32% in 2018, compared to 44% for South Korea, 70% for Malaysia and 176% for Singapore (inflated by entrepot trade hub role). It also seems to be benefitting modestly from some import substitution by US/China arising from the trade war, in products such furniture, gloves, ethylene and polymers of ethylene.

- Philippines' 10-year government bond yield is still hovering a tad above 4% at last reading. Even though it has come down significantly from the ~7% yield at the start of the year, it remains relatively attractive for yield hunters, in an environment where around US$15tn of bonds (25% of market) are trading with negative yields in the DM part of the world. According to recent reports, the government is also looking at innovative debt sales such as prize bonds which other sovereigns offer to individuals.

- The current account deficit has dropped from around 4% of GDP in early 2015 to around -2.6% in 1Q this year. Meanwhile, FDI has been on a sustained uptrend, from around US$5.6bn in 2015 to US$9.8bn last year. While the flows in the first five months of this year (US$3.1bn) was lower than the US$5bn recorded in the same period last year, this was likely due to election-related uncertainties. As this eases, there is a fair chance that FDI could recover in 2H. The Board of Investments has approved 24% more committed investments at PHP312.8bn in the seven months to July, with the top sources being Singapore, Netherlands and Thailand. There are also signs that the government is more focused on attracting FDI this term, with discussions of corporate tax reductions as well as easing of restrictions in foreign employment/foreign ownership limits in utilities/required paid-up capital for entrants into retail etc.

- **Upside Risks to USDPHP forecast:** There are risks to our outlook on the Peso. If the trade war escalates to new highs, there is a chance that foreign investors will shun EMs as a whole, despite resilient macro fundamentals in Philippines. MTD net outflow from equities is at -US$234mn (as at 29 Aug), showing some signs of dampened sentiments seeping in. If stimulus measures and monetary policy easing fail to translate into discernible support for the economy, investor confidence could be further dampened. These factors could pose greater-than-expected downward pressure on PHP.

- **Growth and Inflation Outlook:** 2Q GDP came in softer at 5.5%y/y, vs. 5.9% expected. Domestic demand growth was sluggish, due in part to slightly softer private consumption (5.6%y/y vs. 6.1% prior) and public consumption (+6.9%y/y vs. +7.4% prior). Gross fixed capital formation actually saw a decline (-4.8%y/y vs. +5.7% prior), reflecting the impasse in Budget 2019 disbursements as well as the ban on government spending during the May mid-term elections. Meanwhile, net external demand rebounded (+33.0%y/y vs. -20.0% in 1Q), as exports of goods and services grew (+4.4%y/y vs. +5.7% prior) amid stagnant imports of goods and services (+0.0%y/y vs. +8.6% prior). Industry breakdown showed construction sector contracting while manufacturing growth eased and services growth improved. Manufacturing PMI for Jul rose to 52.1, from 51.3 in June, reflecting some improvement in growth momentum at the start of 2H.

- The overall outlook remains cautious, amid turbulent global trade tensions (US/China, US/EU, Japan/Korea). But with both the Budget 2019 impasse and government spending ban out of the way, our

Economist expects growth in 2H 2019 to rebound to 6.5% alongside higher government outlays and infrastructure spending, on top of the impact of BSP's monetary policy easing. 2019 real GDP growth forecast is maintained at +6.0%, while 2020 growth forecast is trimmed to +6.3% from +6.5% due to challenging external demand conditions. Further out, some positive news regarding the progress of the government's Build Build Build programme—21 out of 75 flagship projects (indicative investment of PHP2.42tn) could be completed by 2022—could support sentiments regarding the economy's medium-term prospects.

- Headline inflation eased towards 2.4%y/y in July, from 2.7% in June and 3.2% in May. The moderation in food & non-alcoholic beverages, housing, water, electricity, gas & other fuels and transport prices was the main cause of the softer inflation figures. Core inflation also eased to 3.2%y/y in July (vs. 3.3% in June). Given that YTD headline inflation is averaging around +3.3% and that inflation is expected to stay subdued for the rest of 2019 on moderate global growth and stable commodity prices, our Economists maintains their 2019 and 2020 inflation rate forecasts at +2.6% and +3.0% respectively (i.e., within BSP target of range of 2%-4%). In comparison, BSP had recently revised downwards both their 2019 and 2020 inflation rate forecasts to +2.6% and +2.9% respectively, from June 2019's projections of +2.7% and +3.0%. BSP also commented that the risk to inflation outlook is broadly balanced in 2019, 2020 but tilted to downside in 2021 on possible slower global economic growth.

- **Monetary Policy Forecast:** As expected, BSP cut policy rate by 25bps from 4.5% to 4.25% on 8 Aug. This is after the "prudent pause" in Jun 2019 to assess the impact of the recent -25bps policy rate cut in May 2019, as well as the series of banks' RRR cuts in May-July 2019. Notably, the surprise/more aggressive rate cuts by RBNZ, RBI, BoT in the same week did not seem to have nudged BSP towards an even more dovish stance. Our Economist notes that the latest Monetary Policy Statement (MPS) continues to project recovery in household spending and accelerated implementation of the government's infrastructure spending program. With receding inflation and 1H 2019 growth below expectations, and another three policy meetings for the year, they expect BSP to deliver another -25bps cut in 4Q 2019 to bring the policy rate down to 4.00%. This is in line with BSP Governor Diokno's comments. He said that at least one more 25bps rate cut will be implemented before year-end, but stopped short of committing to further rate cuts.

- Last year, BSP cut RRR twice, i.e., -100bps on 2 Mar 2018 to 19% from 20%, and another -100bps on 1 June 2018 to 18%. After the policy rate cut in May 2019, BSP had subsequently announced the schedule of the -200bps RRR cuts to 16% in stages; -100bps on 31 May, -50bps on 28 Jun, and -50bps on 26 Jul 2019. More RRR cuts cannot be ruled out, as hinted by Governor Diokno.

- **Latest Fiscal and External Balance Outlook:** Budget Balance in Jul came in at -PHP75.3bn (-US$1.44bn) deficit, larger than the -PHP41.8bn (-US$818mn) deficit in June. For the first 7 months of 2019, the budget deficit also narrowed by almost three-fifths on year-ago basis to PHP117.9bn (US$2.26bn), although part of the "better" outcome was due to delayed implementation of some Budget 2019 initiatives.

- Congress seems to be moving fast to approve the National Budget this year, in an attempt to prevent potential delays that could weigh further on growth. Deficit could potentially remain around ~3% of GDP. We note that the sharp 82.5% jump in government debt to PHP840.8bn in 1H, from PHP460.8bn in the same period last year, could have raise concerns of fiscal sustainability somewhat, although this is mitigated by the fact that majority of borrowings are from local sources, and offshore loans are in the form of development assistance loans from multilateral lenders and bilateral development partners. Government officials have commented that the debt-to-GDP ratio will likely remain manageable, within 36.3%-41.0% between now and end-2022, "showing the resiliency of the debt portfolio against macroeconomic shocks and increased funding needs".

- BoP posted a surplus of $248mn in July (vs. -$404mn deficit in June). On a cumulative basis, BoP for Jan-Jul posted a surplus of $5.04bn vs. a deficit of $3.71bn in the same period in 2018. Strong performance of BoP can be attributed to remittance inflows from overseas Filipinos during Jan-Jun and net inflows of foreign portfolio investments during Jan-Apr and Jul.

- **Current account deficit remains at 2.6% of GDP** but IMF expects an improvement to 2.2% of GDP in 2019. Governor Diokno had said he was "not at all worried about CAD especially if deficit is less than 3% of GDP as the composition of imports was for raw materials, equipments… BoP position is manageable and provides resilience against external headwinds… external position is adequately supported by structural sources of FX inflow such as OFWR, IT/business-process outsourcing revenues and tourism receipts". His comments were also consistent with S&P's recent assessment—"the deficit is largely investment driven, and that this is a healthy development in light of its historical underinvestment".

- The S&P upgraded Philippines sovereign credit rating to BBB+ earlier this year (30th Apr). The rating agency cited strong economic growth trajectory, solid government fiscal accounts and sound external settings for its upgrade to the Philippines ratings. This should support investor sentiment and spur inflows into Philippine assets, supportive of the PHP. The recent approval of sin taxes on liquor, heated tobacco and vapor products, and the proposed new corporate income tax regime (rationalizing fiscal perks to investors while also gradually reducing corporate tax rate from 30% to 20% over 10 years), could potentially help improve sentiments regarding fiscal coffers, or even help boost PH credit ratings in the longer-term.

- **Key domestic events and issues to watch:** Aug Mfg PMI (2 Sep); Aug CPI (5 Sep); Jul trade (10 Sep); Jul Overseas remittances (16 Sep); Aug BoP (19 Aug); Aug Budget Balance (23 Aug); BSP Policy Meeting (26 Sep).

- **Technical Outlook:** Sharp rise in USDPHP in Aug started losing momentum around the 52.5 levels. Last seen at 52.13 levels. Daily momentum turned mildly bearish, while stochastics is dipping towards near-oversold conditions. Technically there may be further downsides to go, if 52.5-level holds. Nearby support at 52.0 (21 DMA) before 51.60 (50 DMA, 23.6% fibo retracement of Oct high to Jul low), then 50.80 (double bottom). Resistance at 52.62 (recent high, 50% fibo retracement), then 53.0.

THB: Semi-Safe Haven Characteristics

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDTHB	30.80 (--)	30.60 (--)	30.40 (--)	30.20 (--)

Forecasts Unchanged

- **Motivation for the FX View:** Forecasts are unchanged from last month, unlike most other USD-AxJ pairs, despite the re-escalation in trade tensions. The main reason is that THB's regional safe haven characteristics came through more strongly in August, amid higher level of uncertainty in global trade relations. USDTHB traded largely between 30.7 and 30.9 for the first three weeks in Aug, and even when China/US announced new tariffs, it reacted by heading towards 30.6 (i.e., THB strengthening). We expect THB to remain relatively resilient amid swings in sentiments related to the state of global trade policy. Meanwhile, BoT's implementation of measures targeted at foreign inflows—i.e., reducing limits on outstanding balances of non-residents' THB accounts (see piece here) should cap the extent of any THB strengthening. We hence look for two-way ranged trades for the rest of the year, with perhaps a slight downward bias in the USDTHB pair (i.e., slight THB strengthening) in 4Q, alongside proof from the new Thai government with regards to its capability to implement pro-growth policies. Subsequently, there could also be a potential recovery in regional sentiments next year, perhaps alongside some concretization of trade deal details between US and China before the US elections in Nov 2020, which could lead the THB on a more sustainable strengthening path (i.e., downtrend for USDTHB).

- A recent report by our Economists showed that there were winners/losers from the trade conflict among the AxJs. While not a clear winner, Thailand was seen benefiting to lesser extents as well, from diversion flows. Customs exports in July had rose by 4.3% (first positive growth in 9 months; vs. -2.2% in June). Although gold was the main driver of the recovery, exports excluding gold had also improved to -0.4% (vs. -8.7% in June). With such positive signs, we think markets will look beyond the 2019 export softness and focus on the healthy current account surplus projection for the year (>6% of GDP) in assessing macro conditions. Nonetheless, a risk to this view is US' ongoing review of Thailand's Generalized System of Preferences (GSP) status, with the US citing market access for US porks and worker rights as reasons for the review. Up to US$4.3bn worth of goods (1.7% of exports) currently covered under GSP could be negatively impacted if GSP status is revoked.

- Meanwhile, net portfolio flows over the past month have turned negative. Aug data (as at 28 Aug) shows net outflows of around -US$1.7bn from Thai equities and -US$904mn from Thai bonds, compared to figures of +US$653mn and -US$811mn in the previous month. The declines could be due in part to continued effects of BoT's latest restrictions on non-residents' THB account balances (effective on 22 Jul), which was aimed specifically at curbing THB strength. Officials also confirmed that cuts in bond supply were utilized for the same purpose. Alongside signs of weaker/negative foreign flows, we think that an escalation of foreign capital controls is not likely in the near term; rather, officials are more likely to continue to rely on existing means to discourage currency speculation. The reduced risks of further capital control measures might also support THB sentiments in the near term.

- A third factor, which is playing out quite prominently recently, is THB's positive correlation with gold prices. A 52-week rolling correlation of THBUSD and gold prices reached a high of around 0.93 in early August, compared to a recent low of 0.73 in Aug 2018. Thailand is a regional gold hub, and Thai gold traders' profit-taking in times of gold price increases could increase demand for THB alongside gold sales. Firm gold prices (currently >US$1500 levels) could see THB supported somewhat. As proof that this channel is in play, we note that gold exports from Thailand saw +407%y/y growth in July, driven by higher demand in Switzerland, Singapore and Australia amid the uncertain economic environment.

- Fitch had revised its outlook on Thailand (long-term foreign currency issuer default rating) to Positive from Stable, and reaffirmed the rating at "BBB+" in July, based on their views that lingering political risks were unlikely to derail sound macro-economic management. This conflicts somewhat with World Bank comments (also in July) highlighting politics remaining as a key risk for the Thai economy. On the ground, some observers have commented that the new Cabinet is "dominated by patronage politics and paybacks", and various members are known to have questionable reputations and capabilities. There were also news that Thailand's ombudsman had ruled this past Tuesday that the prime minister's failure to recite a key sentence ("I will also uphold and comply with the constitution of the kingdom in every aspect") in his oath of office was unconstitutional, and will refer the matter to the Constitutional Court to decide whether the government was legally installed.

- On balance, we assess political risks to remain intact, but think that it is unlikely to derail policymaking by the current coalition. Admittedly, it will take time for residual risks to be resolved and for investors to trust in the policymaking capabilities of the 19-party coalition. Concomitantly, business and consumer sentiment indices slipped again in July. Over time though, the unfair advantage that the Junta-coalition have in government (i.e., the presence of the 250-member senate which was chosen by the Junta) should allow them to push through most pro-growth policies and market confidence could gradually improve.

- **Growth and Inflation Outlook:** 2Q GDP growth (+2.3%y/y vs. +2.8% in 1Q) eased to a 5-year low as domestic demand dampened further, adding to concerns over the sharp decline in exports (-6.1%). The slump in exports was due to weakness in both goods (-5.8%) and services (-7%). The National Economic and Social Development Council (NESDC) downgraded its 2019 GDP forecast range to 2.7% to 3.2% (from 3.3% to 3.8%), and now expects a decline in exports of goods & services (-1.2% from previous +2.2%). At its last policy meeting on 7 Aug, the BoT also expects growth to slow below potential (without providing specific forecasts, but likely lower than the last growth estimate of 3.3% provided in June). Tourism might also see softer outcomes this year, alongside the stronger THB and a positive base effect in 2H. We caution for further growth downsides should there be greater-than-expected delays in the disbursement of Budget 2020 and corresponding postponement in some state investments. The outlook for 3Q remains muted with the consumer confidence index posting a 2-year low in July. Farm income in 2Q (+0.3%y.y vs. +2.7% in 1Q) barely grew due to the decline in agricultural production (-1.6% vs. +3.4% in 1Q), potentially due to drought conditions in some regions. Our Economists sees outlook for the second half to remain weak and maintains full-year GDP forecast at +2.8% for 2019, +3.4% for 2020.

- Headline inflation inched up slightly to +1.0% in July (vs. +0.9% in June), mainly due to higher fresh food prices, especially in fruit and vegetables, pork and rice. Energy prices continued to fall, by -3.3% (vs. -3.9% in June), registering the third month of decline. Core inflation (excluding raw food & energy) dipped slightly to +0.4%, from the previous month's +0.5%. BoT expects inflation pressures to remain benign (i.e., 1.0% in 2019), around the lower end of the BoT's 1%-4% inflation target. Our Economists expect headline inflation to come in slightly below this target due to subdued energy prices and softer demand-pull inflationary pressures.

- **Monetary Policy Forecast:** At its 7 Aug policy meeting, the BoT monetary policy committee had voted 5-2 to reduce the benchmark one-day repurchase rate by 25bps, to 1.5%, effectively joining the global easing wave. Concerns over slowing growth were viewed to have outweighed financial stability risks (household debt at 78.6% of GDP as of end-2018). Effectively, the Bot is expecting its micro- and macroprudential measures to do more of the heavy-lifting in addressing financial stability risks. The dissenters had opted to hold as they viewed that cutting rates might not be effective in stimulating growth, and there was a need to preserve policy space in this uncertain environment.

- Following the surprise cut, our Economists now expect BoT to keep its policy rate at 1.50% throughout the rest of 2019 and 2020. Further easing is likely only if the economy is at risk of slipping into a recession. The last time BoT cut its policy rate lower than the current rate to 1.25% was during the Global Financial Crisis (Apr 2009) when GDP growth was plunging sharply at -4.3% in 1Q09. BoT had also emphasized previously that it would not use policy rate cuts to ease

THB appreciation. Government officials have said that there is room to cut further, but "it's still early to say that there will be another" rate cut.

- **Latest Fiscal and External Balance Outlook:** With the recent convening of the new cabinet, the wheels of the new government are finally starting to turn. The draft Budget bill is expected to be debated by the lower house in September in its first reading, with the second and third readings in December before it is forwarded to the senators for consideration. For now, the government plans to spend around US$32.5bn in 2H to help stabilize the economy. Total FY2020 expenditure is expected to come in around THB3.2tn, with revenues projected at THB2.73tn. This will lead to a budget deficit of THB469bn, or around 2.6% of GDP. Meanwhile, to anchor growth above 3%, an interim stimulus package of around THB316bn has been announced, including soft loans to be provided by state banks, additional cash handouts to welfare card holders for two months, and subsidy for rice planting costs. To boost tourism, visa fee waiver for visitors from countries such as China and India will also be extended.

- The trade surplus was narrower in July (US$110mn vs. US$3.2bn in June), alongside a recovery in both exports (+4.3% vs. -2.2% prior) and imports (+1.7% vs. -9.4% prior). The robust exports performance was due to a surge in gold exports. Agriculture products rebounded but other major items such as electronics and vehicles continued to decline. Exports to US (+9.8% vs. -2.1% in Jun) also surged strongly, with items including clothes (+12%), house tableware & kitchenware (+189%) and furniture & parts (+93%), posting rapid growth. This suggests some trade diversion from US-China trade tariffs, which bodes well for Thailand. Our Economists remain cautious on the exports outlook as gold exports are volatile, and the US-China trade war is escalating with more US/Chinese tariffs kicking in from 1 Sep. Despite potentially weaker trade flows, the current account balance is still expected to remain healthy at above 6% of GDP for the year.

- **Key domestic events and issues to watch:** Aug CPI (2 Sep); Aug Consumer Confidence (5 Sep); Aug Car Sales (18-23 Sep); Aug Customs Trade (20 Sep); BoT Benchmark Interest Rate (25 Sep); Aug Manufacturing Production (27-30 Sep); Aug Trade and BoP (30 Sep).

- **Technical Outlook:** Levels last seen at 30.61. Momentum indicators on the daily charts show a modest bearish bias, while stochastics are in oversold conditions. Stochastics on weekly charts are also in oversold conditions. We see chance of an upward movement in USDTHB pair in the interim, perhaps towards 30.76 (21 DMA). Other resistances at 31.07 (Feb low), then 31.27 (50% fibonacci retracement from May high to June low). Support at 30.50 (recent low in early Jul).

INR: Beyond the Month of Volatility

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDINR	70.00 (69.50)	70.00 (68.80)	69.00 (--)	68.50 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** Equities were sold off for much of the month, offsetting the bond-related inflows. Risk-off drove the unwinding of carry trades and weakened the INR as a result. We think that there is a sense of uncertainty on the US-China trade talk front that could persist into much of the rest of the year and carry trades would not be in vogue for a while. That would also require an adjustment in the INR forecast lower to 69.50 at the end of the year, still higher from where it is right now as we do not expect there to be a lot more escalation either.

- **Domestically,** the government just eased the rules for foreign direct investment in retail, manufacturing and coal mining in a bid to lift growth. Limits on investment in commercial coal mining and contract manufacturing are abolished. Local sourcing norms eased for FDI in single-brand retail companies who are also now allowed to set up online sales prior to opening of brick and mortar stores. Easing FDI restrictions may allow foreign investors such as Apple to sell products more easily to India's large consumer base.

- We changed our base case to a slightly less optimistic one as we do not look for a US-China trade deal within this year and instead, expect one to be reached some time in 1H2020. The uncertainty and risk of escalation could continue to keep the USDINR elevated at around 70.00 for the rest of the year with some potential for further downside should there be any positive development coming out of the US-China trade talks which typically generate recoveries in the Asian-ex Japan FX. The month of Aug might have shaken confidence in the INR but into the end of the year, we anticipate mild recovery as sentiments improve especially with face-to-face talks resuming between the US and China in early Sep (as soon as next week).

- **Growth and Inflation Outlook:** Industrial production eased to 2.0%y/y from previous 4.6%, weighed by slower output from mining and manufacturing, a sign that weakening external demand crimped on domestic activity. Breakdown by use-based suggests that output of primary goods have weakened to 0.2%y/y from previous 0.8%. Capital goods contracted -0.5%y/y from previous -0.1% and intermediate goods weakened to 2.0%y/y from previous 2.2%, in line with the central bank's concern about widening output gap.

- PMI-mfg for Jul rose to 52.5 from previous 52.1. However, the pro-long trade tensions and protectionist measures imposed have also started to affect India, not helped the least by US decision to remove the beneficial trade status for India's exports on 5 Jun. Exports growth remained anemic. Exports growth came in around 2.3%y/y for Jul, albeit rebounded from -9.7% previously. Trade deficit narrowed to $13.4bn as imports fell by a steeper -10.4%y/y vs. previous -9.1%, another reflection of the soft domestic demand. More recently, the government will spend INR62.68bn to subsidize the exports of up to 6miliion tons of sugar in this fiscal year, in a bid to support the farmers at home.

- Inflation slipped to 3.15%y/y from previous 3.18%, weighed by the -0.358%y/y drop in the fuel and light subcomponent. However, that drop was offset by the firmer costs of food which accelerated to 2.36%y/y from previous 2.25% as well as housing at 4.88%y/y. WPI also came off, more than expected to 1.08%y/y from previous 2.02%, a sign of narrowing margins and weaker pricing power. Looking forward, Monsoon deficit seems to be narrowing and that could alleviate some food inflation and keep inflation in the lower bound of 4% (+/-2%) target.

- 2Q GDP is out on the 30th of Aug and pick-up in the output for the first two months of the quarter so far suggest that growth should come in a tad firmer but weaker net exports should detract from the headline.

- **Monetary Policy Forecast:** RBI lowered repurchase rate by 35bps to 5.40% from 5.75% in Aug. Reverse repo rate is also cut to 5.15%. Cash reserve ratio is left unchanged at 4.00%. Equity and bonds were lifted at first before coming under pressure. 10y yield was pressed lower to around 6.272% before retracing higher to levels around 6.35% when it was revealed that the decision to cut rate was not a unanimous one with 4 members voted for 35bps cut and 2 who voted for a 25bps reduction.

- Governor Das emphasized on the central bank's focus to "fill output gaps" and that India is in a cyclical slowdown, not structural. He also explained that RBI had delivered an unconventional 35bps cut because "the standard 25bps cut may not be adequate" and "50bps cut" could be excessive given the fact that RBI already had 3 back to back cut this year that were "pre-emptive" already.

- Transmission mechanism of the easing so far is still weak and with the Minutes of the RBI policy meeting for Aug still indicating widening output gap for the economy, expectations are still for RBI to ease by another 25bps in Oct. We see a risk of RBI cutting rates as well as data over the past month has been too weak. The weighted average call money rate (WACR) dropped 29bps over the recent easing cycle (Feb-Jun).

- **Latest Fiscal and External Balance Outlook:** The record INR1.76trn transfer of the RBI dividends to the government could help MOF to roll out its fiscal stimulus package. Current account for 1Q 2019 narrowed to $4.63bn from previous $17.74bn. Trade deficit of goods narrowed to $35.21bn from $49.3bn.

- **Key domestic events and issues to watch:** 2Q GDP is due on 30th Aug; PMI Mfg (Aug) on 2nd Sep; BoP current account (2Q) on 5-30th Sep; CPI (Aug) and industrial production (Jul) on 12th; trade data on 12-15th; WPI on the 16th.

- **Technical Analyses:** The 1M USDINR NDF is poised stochastics on the daily chart suggests that this pair has started to turn lower with the break out of the rising wedge. We continue to look for this pair to head towards 71.50 before 71.00. Momentum has turned bearish. The gap-up from 70-figure could be filled.

VND: Steady in Volatility, Weakness in Regional Recovery

Forecast	3Q 2019	4Q 2019	1Q 2020	2Q 2020
USDVND	23300 (--)	23200 (23100)	23100 (23000)	23000 (22900)

Previous forecasts in Parenthesis.

- **Motivation for the FX View:** Solid growth momentum and external demand is still the story for Vietnam and the VND is poised to remain steady. USDVND could remain at current levels. We see potential for VND to remain resilient against the USD as Vietnam comes under pressure to open up its market access to foreigners. With Vietnam still under the US Treasury watch list for currency manipulation, VND turned out to be one of the most resilient currencies in the region as we have forewarned in the last issue of the FX Monthly. Exports to the US have been in double digit growth since Jul last year and Vietnam just clocked the highest trade surplus with the US ever seen at $4.25bn. Outperformance of the VND is due not just to the trade. Supply chain diversion away from China also contributed to the surge in FDI inflows into its manufacturing sector and strengthened the VND.

- We recall US Trade Representative Lighthizer call for Vietnam to cut its trade surplus (failing miserably) with the US and to increase market access for foreigners. Vietnam's exclusion of Huawei network hardware for its mobile carriers (citing network safety) also underscores how much Vietnam values the support of the US. As Vietnam has already exhausted the first six months of the year to keep the VND weak, the active management by the SBV is unlikely to continue for the rest of the year as VND is still on US watchlist for currency manipulation.

- In an environment of USD strength, VND's competitiveness against its trading partner slipped more in Aug. Our estimate of the VND trade weighted index (TWI) rose to 65.5 from previous 64.5, a +1.5% appreciation on the trade-weighted basis as most other trading partners weakened a lot more the VND, including CNY. In an environment of trade truce however, we anticipate the recovery in the VND to lag that of the region and the competitiveness of the VND could be clawed back.

- **Growth and Inflation Outlook:** Growth momentum remains solid compared to its peers. Industrial production quickened to 10.5%y/y from 9.7%y/y previously. Manufacturing output softened to 10.3%y/y vs. 10.4% alongside electricity output which also decelerated a tad to

10.3%y/y from previous 10.5%. "Water Supply" and "Mining & Quarrying" accelerated with the former firming to 7.6%y/y from previous 7.4%. The Mining and Quarrying surged to 14.4%y/y growth vs. previous 4.4%.

- Private consumption as proxied by retail sales remained buoyant at around 11.5%y/y in Aug vs. previous 11.6%. This was underpinned by strong visitor arrivals and tourist receipts that steadied around 12.1%y/y growth for the year so far.
- Exports growth slipped to 4.5%y/y in Aug from 9.3% previously, undershooting expectations at 7.0%. Imports on the other hand picked up pace to 7.5%y/y vs. previous 5.0%. Trade surplus still ballooned to to $1700mn from previous $200mn. Exports to the US have been in double digit growth since Jul last year and Vietnam clocked the highest trade surplus with the US ever seen at $4.25bn for Jul this year. Optimism on its trade could be dampened by recent comments by US trade representative Lighthizer who urged Vietnam to cut trade surplus with the US and to open its markets to more US goods and services. (In response, Deputy Spokesperson Vietnam Foreign Ministry Nguyen Phuong Tra aid that Vietnam has "made multiple efforts" to increase imports of US products and to improve the investment and business environment for US firms.) Vietnam is on the watch-list of the US Treasury for currency manipulation and could mean less depreciation pressure for the VND vs. the USD over the next few months as SBV could adjust its foreign exchange management.
- Total registered FDI for the first 7 months of 2019 was up -210%y/y on low base effects due to exceptionally large FDI inflows seen in Jul last year. This measure tends to be chunky and in absolute terms, the amount of FDI inflows is still a healthy $855mn for Aug.
- Inflation actually softened to 2.26%y/y from previous 2.44%, weighed by the softening of the food inflation along with transportation and housing and construction materials. Those negate the rise in health and personal care costs which rose to 8.9%y/y from previous 5.9%.
- Our economic team sees full year GDP forecast at +6.8% for 2019 on robust manufacturing performance, positive export growth and rising FDI along with buoyant private consumption.
- **Monetary Policy Forecast:** With growth outlook still intact and inflation subdued, there seems to be little motivation for SBV to use its monetary policy tools at this point. As for the VND, we see upside risks to the currency as Vietnam continues to benefit from manufacturing and trade diversion flows and FDI that resulted from the US-China trade conflicts though that uptrend could be dampened by recent comments coming out of the USTR office. VND could stand to strengthen further from a stronger demand out of China as China is likely to increase monetary stimulus to support growth momentum and that could in turn increase the demand for Vietnam's exports. We still expect FDI inflows to continue because of the trade agreement/diversions and that could cushion the effects of the decline in external demand. Retail sales suggest that household consumption could also support growth.
- In terms of TWI, the VND strengthened in Aug VND remains shielded from the USD strength because of its relatively closed capital account

and managed exchange rate policy. In addition, positive balance of payment surplus (trade surplus, positive FDI inflows) also underpins the currency. As VND remains under the US watchlist for currency manipulation, we continue to expect limited weakness in the VND. Conversely, competitiveness could be clawed back should progress on the US-China front see regional peers strengthen more vs. the VND.

- **Latest Fiscal and External Balance Outlook:** As of last available data, current account surplus was at U$1.24bn in 2Q. Net trade surplus of goods slipped to U$3.0bn from previous U$5.2bn. The competitive dong could keep the current account in surplus. However, as the US continues to pressure Vietnam to reduce its trade surplus with itself and with VND still on the watchlist, the VND may lose its trade competitiveness and erode the current account surplus.
- **Key Domestic Events and Issues to Watch:** Domestic vehicle sales in 6th-13th Sep; 3Q GDP, Sep CPI, trade numbers, retail sales and IP are due 25th-30th.

FX Forecasts

	End Q3-19	End Q4-19	End Q1-20	End Q2-20
USD/JPY	106	105	106	106
EUR/USD	1.1050	1.1100	1.1150	1.1200
GBP/USD	1.2000	1.2400	1.2500	1.2600
AUD/USD	0.6800	0.6800	0.6900	0.7000
NZD/USD	0.6400	0.6400	0.6600	0.6600
USD/SGD	1.4000	1.3950	1.3900	1.3800
USD/MYR	4.2500	4.2500	4.2200	4.1800
USD/IDR	14200	14200	14100	14050
USD/THB	30.80	30.60	30.40	30.20
USD/PHP	52.50	52.50	52.00	51.50
USD/CNY	7.12	7.20	7.18	7.15
USD/HKD	7.80	7.80	7.80	7.80
USD/TWD	31.50	30.90	30.60	30.50
USD/KRW	1220	1200	1185	1170
USD/INR	70.00	70.00	69.00	68.50
USD/VND	23300	23200	23100	23000
DXY Index	98.42	97.62	97.17	96.69
SGD Crosses	End Q3-19	End Q4-19	End Q1-20	End Q2-20
SGD/MYR	3.0357	3.0466	3.0360	3.0290
SGD/IDR	10143	10179	10144	10181
SGD/THB	22.00	21.94	21.87	21.88
SGD/PHP	37.50	37.63	37.41	37.32
SGD/CNY	5.09	5.16	5.17	5.18
SGD/HKD	5.57	5.59	5.61	5.65
SGD/TWD	22.50	22.15	22.01	22.10
SGD/KRW	871	860	853	848
SGD/INR	50.00	50.18	49.64	49.64
MYR Crosses	End Q3-19	End Q4-19	End Q1-20	End Q2-20
EUR/MYR	4.70	4.72	4.71	4.68
JPY/MYR	4.01	4.05	3.98	3.94
MYR/HKD	1.84	1.84	1.85	1.87
MYR/CNY	1.68	1.69	1.70	1.71
GBP/MYR	5.10	5.27	5.28	5.27
AUD/MYR	2.89	2.89	2.91	2.93
NZD/MYR	2.72	2.72	2.79	2.76
MYR/IDR	3341	3341	3341	3361
MYR/INR	16.47	16.47	16.35	16.39
MYR/KRW	287	282	281	280
MYR/PHP	12.35	12.35	12.32	12.32
CNY/MYR	0.5969	0.5903	0.5877	0.5846

Source: Maybank FX Research as of 30 Aug 2019.
*These forecasts are meant to be indicative of FX trends and not meant to be point forecasts.

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