

FX Monthly

2017, Issue 9: Inflation Expectations, Yield Differentials & China Take Centre-Stage in Oct

What Has Changed This Month?

- We are revising GBP, AUD, MYR and KRW forecast stronger in the medium term whilst revising NZD, INR and IDR forecasts lower. There was slight calibration to USDCNY forecast in 1H 2018. The USD DXY forecast has been adjusted lower accordingly as a result of the combined changes above on the index.

Our Strategies

- US fiscal impulse is likely to be delayed into 2018. Inflationary pressures in US are now still not certain with recent data showing a bit of softness. Nonetheless, US activity seems to remain positive. The Sep meeting suggests that the Fed remains determined to tighten monetary policy as planned, with balance sheet reduction commencing in Oct and dots plot indicating 4 more hikes between now and end-2018. **Our house view remains for a 25bps rate hike, likely in Dec 2017.**
- We maintain our **positive outlook on the EUR in the medium term but caution that the rapid pace of appreciation opens up the vulnerability for short term correction** on political concerns in Germany, Spain and markets coming to terms that ECB removal of stimulus is expected to be gradual. **We see room for EUR to correct lower towards 1.16 - 1.17 levels.** That said we still see risk of ECB announcing plans to normalise monetary policy at the upcoming GC meeting in Oct. Our base case remains for slower asset purchase (EUR40bn) to take place in 1Q 2018. Our tactical short EURGBP has met our objective.
- Global policy unwinding will take shape at differing pace. **We maintain our view of EUR long vs. JPY, on the basis that ECB is likely to normalize policies ahead of BoJ.** We see risk that **BoE could possibly tighten as early as in Nov-2017 and this may lend some support to GBP.**
- Our bearish call on the NZD paid off. We remain bearish on NZD on the back of election outcome uncertainty casting doubts on policy continuity on immigration and trade. A government is expected to be announced between 7 and 12 Oct. **We caution that a grand coalition involving Labour, Green and NZ First will likely point to a more inward looking, nationalist-focused agenda and this may weigh on the NZD.**
- **AUD and CNH may still bear the brunt of China's crackdown on air pollution** as China revokes 1,000 iron ore mining licenses (1/3 of all iron ore mining licenses in China). We see risk of AUD heading towards 0.7730 and USDCNH heading higher towards 6.72 in the short term.
- Amongst AXJs, we are bearish on IDR, KRW, and TWD due a range of factors including idiosyncratic risks and potential rebound in the USD into the year-end. We are neutral on MYR as foreign investors' confidence gradually return in current low volatility and low yield environment. **Our call for MYR to extend gains towards 4.20 levels (vs the USD) has been met last month. We caution for near term retracement risks but bias remains to stay long MYR, on a strategic basis.** We are cautious on INR on the back of twin deficits amid slowing growth momentum. On a relative basis, we favour long PHP short THB and INR.
- **Risk to our outlook:** Any delay in Fed's timeline of normalising monetary policies is likely to impact on asset allocation in ASEAN. At the same time, the low interest rate environment for longer could spur a further re-weighting of equities and re-ignite foreign interest in ASEAN equities. Furthermore our view of global synchronised recovery story should further support inflows into ASEAN selectively.

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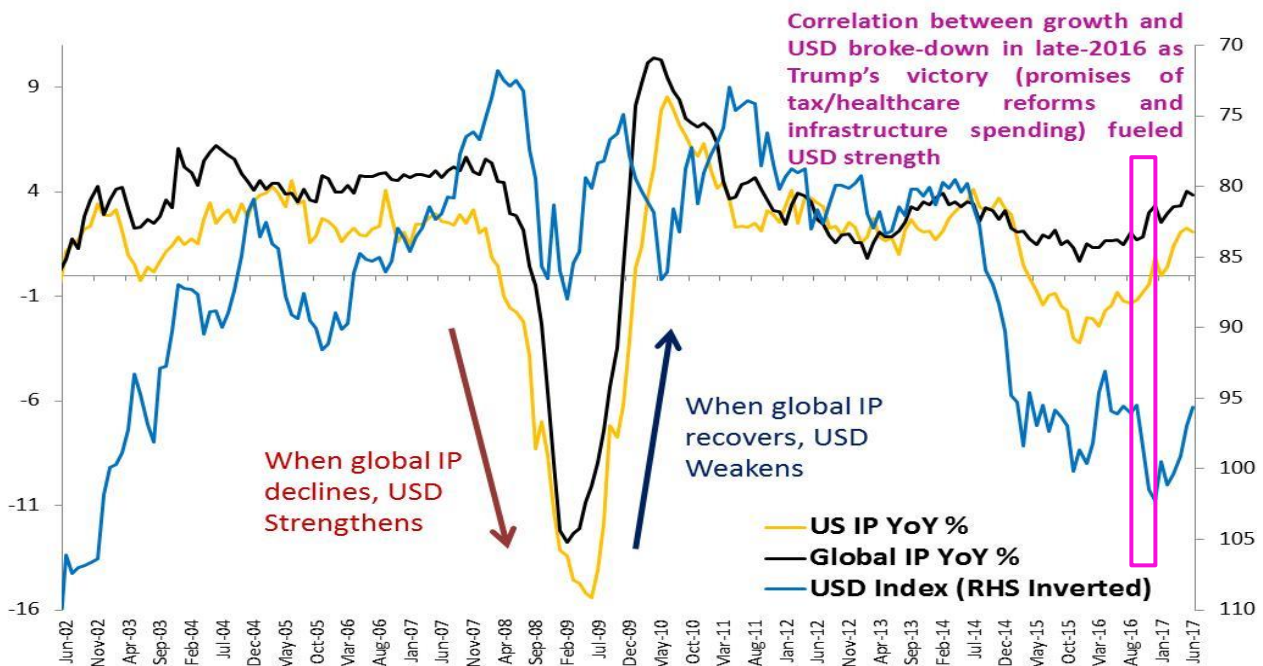
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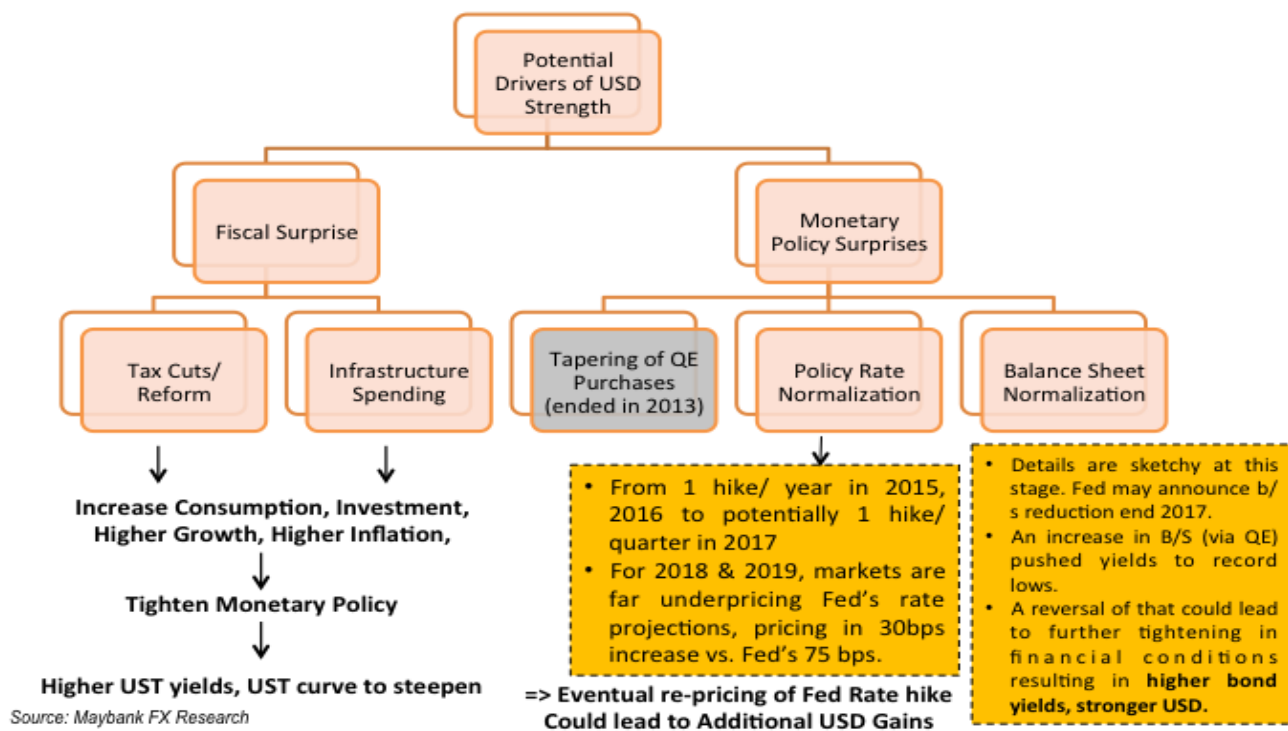
So What?

USD is a Countercyclical Play: Suffers When Global Growth is Well..



Source: Bloomberg, Maybank FX Research & Strategy

Where Can USD Strength Come From?



G7 Global Overview



USD: Potentially Marred by Domestic Politics (Upcoming Debt Ceiling Concerns, Trump-Inspired Volatility), Sep FOMC and Softer Data.

Forecast	4Q 2017	1Q 2017	2Q 2018	3Q 2018
USD Index	93.34 (93.52)	93.11 (93.38)	94.04 (94.22)	92.34 (--)

Previous Forecast in Parenthesis

- Motivation for the FX View:** We expect at least one more rate hike in 2017, more likely in Dec now followed by the announcement of the start of balance sheet reduction possibly as early as Sep 2017. We do caution that additional repricing of a surprise balance sheet reduction over the course of the year could continue to see UST yields higher in particular Treasuries 2y and below, and see USD strength (buy the rumor) in the lead-up to FOMC meetings. The DXY forecasts saw downward revisions due to our upward revisions to the key G7 currencies such as the EUR and JPY. *However, we expect USD to rebound in 4Q this year and early next year with occasional swings within a tight range in the interim by around 5% or so. At current levels, long USD positions vis-à-vis G7 currencies, in particular the euro is beginning to look attractive from a tactical perspective. But medium term, we still expect USD advantage to be eroded by eventual gradual stronger growth trends in rest of the world and assist USD reversion towards fair value but at slower pace compared to the past.*
- The July FOMC statement plus the latest probabilities of Fed's rate hike in the next three remaining FOMC meeting this year derived from the fed fund futures suggests the third rate hike is unlikely to happen at 31 Oct - 1 Nov 2017 FOMC meetings given the above-90% probability of no change, although the odds of a hike at the final FOMC meeting of the year on 12-13 Dec 2017 is now at around 73% with the start of Fed balance sheet's reduction set for Oct 2017.
- We continue to expect domestic data and a repricing of the future stance of monetary policy to support the USD. But given despite recent talks of US tax reforms (materialising possibly as early as in the middle of 2018) and trade policies as well as softer inflation pressures to support a strong US reflation view, we do not expect the Dollar to appreciate as strongly as expected in 2017. Nonetheless during this phase and around FOMC announcements, we believe the USD could still be mildly supported at times given potential concerns about Fed changes in FFR guidance on hikes and balance sheet normalization.
- Growth and Inflation Outlook:** The latest third print of the 2Q GDP came in at 3.1%, slightly higher compared to 3.0% expected. The second quarter upward revision saw increases in inventories while final sales were revised lower in the latest estimate. The latest print

reflects strong underlying momentum, driven by consumer spending and supported by business investment. In order to achieve the Fed's growth forecast of 2.4% for 2017, the economy will need to rise 2.6% in 2H 2017. This is achievable if 3Q downward disruptions are offset by a pickup in rebuilding activity in 4Q.

- NFP in Aug grew lower than expected; coming in at 156K (expected 180K) while the employment for June/July was revised slightly lower by 41K. The NFP report was less positive than others in recent months, with most components either little changed or below estimates. The private sector employment cooled off in Aug with 95K gains a five month low but this was supported by manufacturing and construction robustness. While wage growth was held back by declines in hourly earnings in mining and infrastructure.
- Core CPI inflation came in as expected in Aug, rising 0.2% m/m. On a y/y basis, core CPI was higher at 1.7% against expected 1.6%. Headline inflation rose 0.4% m/m and 1.9% y/y, higher than expected. Increase in the core index was driven by the largest rise in shelter prices since 2005 with the lodging category the main driver. Energy prices also rose significantly since Jan and may have reflected some impact from Hurricane Harvey. Overall the trend in core inflation has been softening in recent months but is likely to rise. Headline inflation measures could remain elevated for several months as the data more fully incorporate the fallout from Harvey and Irma. The Fed's preferred PCE measure has not managed to sustainably meet or exceed the 2% target.
- US retail sales fell 0.2% in Aug, weaker than the 0.1% gain in the consensus. Auto sales, took a hit in Aug, in part due to Harvey.
- **Monetary Policy Forecast:** No change in fed funds rate i.e. 1.00%-1.25%. Fed maintains its guidance of three rate hikes this year and announces the start of balance sheet reduction next month, in line with our expectations of another +25bps rate hike this year and commencement of balance sheet reduction in 4Q 2017.
- Fed will kick off balance sheet reduction in Oct 2017. The plan was earlier unveiled at the 13-14 June 2017 FOMC meeting i.e. reducing the securities holdings in the balance sheet by gradually decreasing the reinvestment of principal payments from matured securities. Currently, Fed fully reinvests proceeds from matured securities, keeping its balance sheet size around USD4.5tr since Sep 2014 following the end of QE Taper.
- The initial size of balance sheet reduction will be USD10b per month (i.e. USD6b in US Treasury and USD4b in agency debt and mortgage-backed securities), and raised by +USD10b every three months (i.e. +USD6b in US Treasury and +USD4b in agency debt and mortgage-backed securities) over a 12-month period until the process reached USD50b per month (i.e. USD30b in US Treasury and USD20b in agency debt and mortgage-backed securities), which Fed expects to be the maximum pace of monthly balance sheet reduction for a gradual and predictable balance sheet normalization process (Fig 2). Fed also added that any amount of maturing US Treasury, agency debt and mortgage-backed securities that are in excess of the monthly reduction size will be re-invested.

- FOMC's median interest rate forecast at end-2017 remains at 1.375% (mid-point of 1.25%-1.50%), and there is no change to the projection of 2.125% (mid-point of 2.00%-2.25%) at end-2018, indicating the guidance for +75bps hikes per annum or three +25bps increases per year for 2017- 2018 is intact. The only tweak is for end-2019 i.e. down to 2.75% (midpoint for 2.50%-3.00%) from 3.00% (mid-point for 2.75%-3.25%), indicating two instead of three rate hikes in 2019 (Fig 8). Fed fund futures market indicates no rate hike at the next FOMC meeting (30 Oct - 1 Nov 2017) and the probability of hike at the 12-13 Dec 2017 FOMC jumped to 63.7% from 50% the day before.
- Fed acknowledges the short term effect from Hurricanes Harvey, Irma and Maria, but sees no material impact on the medium term outlook. In fact, Fed raised its expected 4Q 2017 YoY real GDP growth to 2.4% from 2.2% back in June 2017, maintained the 2.1% YoY forecast for 4Q 2018, and bumped up the projection for 4Q 2019 to 2.0% from 1.9% previously. It also maintained the 4.3% unemployment rate for 4Q 2017, and cut slightly the Figures for 4Q 2018 and 4Q 2019 to 4.1% vs 4.2% previously. Notwithstanding the subdued inflation rate this year (July 2017: 1.4%; 2017 YTD: 1.7%), Fed keeps its faith in inflation rate moving towards its implicit target of 2% over the next couple of years i.e. from 1.6% in 4Q 2017 (unchanged from June 2017 projection) to 1.9% in 4Q 2018 (revised marginally from 2.0% previously) and 2.0% in 4Q 2019 (unchanged).
- Three reasons why Fed takes the plunge despite recent debates and uncertainties about unwinding monetary stimulus. First and foremost, confidence in economic outlook, as reflected by the earlier mentioned macroeconomic forecasts for 2017-2019. Fed will not take the step to signal third rate hike this year - as well as maintained guidance of three rate hikes next year - and proceed with its balance sheet reduction plan if there is doubt on the medium term growth and inflation outlook. This also augurs well for the global economic growth outlook for next year at least, given the current growth recovery that is underpinned by the synchronised pick up in G3 (US, Europe, Japan).
- Fed is also comforted and encouraged by the orderly market reaction to its communication with regards to the balance sheet reduction plan back in June 2017. There is a notable lack of the kind of market turmoil and volatility - especially in the bond market - that followed the QE Taper announcement by former Fed Chair Ben Bernanke in May 2013.
- Another motivation for Fed is the need to address financial stability risk, which is the flipside of the above-mentioned market calm that can be interpreted as market being relatively sanguine about - and by extension mispricing - risks. In the case of inflation outlook, there is currently gap or divergence between Fed and market as the fed fund futures indicates that while market have more or less priced in three rate hikes this year, the expectations are for only one hike in 2018 and 2019 respectively in contrast to Fed sticking to its fed fund rate guidance (Figs 8- 9). This is further compounded by the risk of excesses in the US equity and bond markets from a decade of monetary stimulus, in view of the current elevated level of S&P500 cyclically-adjusted PE ratio and the 3½-decade bond market rally (Fig 10).

- “Hawkish” Fed mildly supportive of US currency and bond yield. Our FX and Fixed Income Research Team expect US Dollar Index and 10-Year US Treasury yield to be at around 93 and 2.50% respectively at end-2017 vs 20 Sep 2017 closes of 92.5 (recent low was 91.35 on 8 Sep 2017) and 2.27% (recent low was 2.04% on 7 Sep 2017).
- **Latest Fiscal and External Balance Outlook:** Fiscal policy should be expansionary over the next few years as the tax reforms take shape and some investment in infrastructure becomes apparent under the Trump administration. The deficit has fallen sharply from its peak. Fiscal sustainability risk continues to weigh on the outlook and may emerge sooner than later. In the long term, an improved US economy and manufacturing sector, US shale oil and gas production may improve the US current account leading to dollar support but this is likely to be long drawn and may probably begin only in 2018. The US other deficits - current account and BOP deficits have moved slightly wider and is expected to continue.
- **Key domestic events and issues to watch in Oct 2017:** Key US events: ISM Manufacturing (2 Oct); Factory Orders (5 Oct); Durable Goods Orders (5 Oct); Trade Balance (5 Oct); NFP (6 Oct); CPI (13 Oct); Retail Sales (13 Oct); GDP 3Q (27 Oct); PCE Deflator (30 Oct), Housing Starts (18 Oct); FOMC Meeting (21 Sep); FOMC Meeting Minutes of Sep 20 (12 Oct).
- **Technical Outlook:** DXY closed firmer in Sep for the first time in 6 months. Index rebounded to close above 93 levels, in line with our caution for risk of rebound in Sep FX Monthly Outlook. We shared that Support at 91.40 (50% fibo retracement of 2014 low to 2016 high) should hold, with resistance at 93.20. DXY was last seen at 93.50 levels. Weekly momentum has turned mild bullish. Rebound could extend. Resistance at 94.30 (38.2% fibo retracement of 2014 low to 2016 high). Support remains at 91.40.



EUR: Near Term Correction; Medium Term Positive

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
EURUSD	1.2000 (--)	1.2000 (--)	1.1800 (--)	1.2100 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** We reiterate our short term view for EUR to correct lower from its sharp run-up (+10% since mid-Jun) in a relatively short space of time (3 months since mid-Jun). We think the case for deeper correction on the EUR is not impossible as (1) German election results weigh on sentiment; (2) Catalanian referendum for independence (no legitimacy) raises the risk of civil unrest further weigh on sentiment and (3) market gradually come to terms that ECB policy normalisation will be slow as inflation pick-up remains gradual.

We do not rule out a move lower towards 1.1680 levels in the near term. But maintain an overall positive outlook on the EUR as German election results is only expected to pose short term negative repercussions. Our out-of-consensus EUR forecast of 1.18 for end-3Q came to fruition (closed at 1.1814 for quarter-end). We maintain our FX forecasts over the forecast horizon.

- We reiterate our case for being patient in buying EUR on dips as sustained signs of economic recovery is broadening in Europe and that ECB is on gradual path towards policy normalisation. Forward looking surveys suggest that growth momentum remains robust. Preliminary composite PMI for Sep rose to 56.7 (vs. 55.7 prior), helped by both manufacturing PMI which rose to 6-year high and services PMI. Though inflation ticked higher, core inflation remains stuck at 1.2% hence our call for ECB policy normalisation to be slow and gradual as inflation pick-up remains gradual. We expect EUR to climb higher towards 1.20 - 1.22 levels end this year. We do however flag that the risk of Italian election (which has to be held by mid-2018) may pose some downside risk on the EUR at some stage.
- We see some downside risk in the interim arising out of political risks: (1) Merkel's party suffered its worst result in a national election since 1949. And the results mean she needs to build a 3-way coalition in order to form a government. The rise of right-leaning Populist Party, AfD into German parliament for first time since World War II pose threat to Euro-zone integration and EUR as they campaigned on an anti-immigration, anti-EUR platform; (2) Catalan referendum results (1 Oct) which sparked risk of civil unrest may weigh further on EUR. While 5m were eligible to vote, only about 2.3m votes were cast in total but 2m votes supported independence. Catalan separatist leaders signalled they may declare independence within a week. Spanish PM Rajoy insisted that the vote has no legitimacy. Other downside risks to our outlook include the return of monetary policy divergence with Fed especially if US data (in particular inflation, wage growth) surprise sharply to the upside. That will encourage market to further re-price Fed's monetary normalisation plans and put upward pressure on UST yields and the USD. This will then weigh on EUR.
- **Growth and Inflation Outlook:** In the last quarterly assessment report (7 Sep), ECB revised 2017 growth to 2.2% (vs. 1.9%), which would be the fastest rate of growth since the 3% growth seen in 2007 before GFC. Growth is broad-based and 6 million jobs were created since 2013. The ECB kept 2018 and 2019 growth forecast unchanged at 1.8% and 1.7%, respectively.
- Euro-area recovery continues with 17 quarters of growth while unemployment fell to 9-year low of 9.1%. 2Q GDP growth accelerated to 0.6% q/q (vs. 0.5% in 1Q). And on y/y basis, GDP growth rose to 2.3% (vs. 1.9% in 1Q). This is the best level in 5 years. Forward looking surveys also suggest that growth momentum remains robust. Preliminary composite PMI for Sep rose to 56.7 (vs. 55.7 prior), helped by both manufacturing PMI which rose to 6-year high of 58.2 vs. (57.4 prior) and services PMI rebounded (55.6 vs. 54.7 prior). Breakdown by country also saw improvement in Germany and France. Taken

together, 3Q GDP growth may show acceleration in economic expansion.

- In the last quarterly assessment report (7 Sep), the **ECB kept inflation forecast unchanged at 1.5% for 2017** but lowered inflation forecast due to currency strength for 2018 and 2019 to 1.2% (from 1.3%) and 1.5% (vs. 1.6%), respectively. Our inflation forecast shows headline inflation may reach a high of 1.5% in 3Q (still below ECB's "around 2%" target) before easing off towards 1.2% in 4Q 2017 and then gradually pick up again for 2018 and 2019.
- **Euro-area inflation rose to 1.5% y/y in Aug**, owing to energy prices. Core inflation (ex food and oil prices) held steady at 1.2% in Aug. While inflation has picked up gradually, it remains well below ECB's policy mandate to maintain inflation rate below but close to 2%. Current level of inflation confirms Draghi's point that core inflation has yet to see a meaningful recovery. A stronger EUR (more than 6% rally in the EURUSD since late-Jun and more than 15% gains YTD to Sep high) could also weigh on imported prices (imported consumer products account for around 15% of industrial goods in the Euro-area) and result in negative feedback loop to core inflation.
- **Monetary Policy Forecast:** For the upcoming meeting on 26 Oct, we expect ECB to keep monetary policy rates unchanged but **sees risk of ECB announcing plans to normalize monetary policy in the form of slowing its asset purchases gradually** (which is currently at a pace of EUR60bn per month) in Jan-2018 after the current program expires in end-2017.
 - One potential option is to phase in slower purchase of EUR40bn for a few months (starting Jan-2018) before reducing it to EUR20bn then to nil over the course of 2018, with option to adjust the pace of purchase as ECB deems consistent with achieving inflation objective. We still expect ECB to maintain a considerable degree of monetary accommodation for inflation dynamics to become durable and self-sustaining. Take note that this is not to be confused with what the Fed is currently contemplating with its unwinding of balance sheet.
 - Another possible option (not our base case scenario) is that ECB ends QE purchase (with no taper) when the current QE program ends in end-2017. This option is likely to see financial conditions tighten by a fair bit and could result in markets chasing for EUR longs. We do not expect ECB to pursue this option as ECB desires for favorable financial conditions as a necessary to secure a sustained convergence of inflation rate towards levels below but close to 2% target
- **At the last meeting on 7 Sep**, benchmark rates and asset purchase were kept unchanged as expected. ECB upgraded growth forecast for 2017 but lowered inflation forecasts for 2018 and 2019 (due to gains in EUR). Press conference covered a wide range of topics: (1) Currency - Draghi said the recent volatility in EUR represents a source of uncertainty which requires monitoring with regard to its possible implications for medium term outlook for price stability but he also said that the exchange rate is not a policy target though he added that it is *important and very important for growth and inflation*. (2) Timing of QE exit - He said that the ECB's GC will likely discuss the

future of its asset purchase program in its 26th Oct meeting and further mentioned that the bulk of the decisions it will make on policy calibration will probably be in Oct. However subsequent headlines published by media show that EUR strength remains a key concern and results in ECB officials at odds on QE exit date.

- To recap, QE was extended beyond Mar 2017 for another 9 months to end-2017, at a reduced pace of €60bn per month. There were also a handful of technical tweaks to the APP to ensure smooth implementation of the program. Our take is ECB's monthly purchase after Apr 2017 may seem like a tapering at first glance but in actual fact, the option chosen between the 2 (either €80bn per month for 6 months or €60bn per month for 9 months) implies a larger QE amount (€540 bn).
- **Latest Fiscal and External Balance Outlook:** Euro area's current account surplus widened to EUR25.1bn in Jul (from EUR22.8bn in Jun) on higher primary income balance while secondary income widened. Current account surplus to GDP narrowed slightly to 3.0% (vs. 3.1%) for 12-month period ending Jul 2017.
- The government deficit ratio is projected to decline to 1.5% in 2017, from 2.1% of GDP in 2015. Projected government debt ratio is projected to decline gradually to 88.4% in 2017, from 91.5% of GDP in 2015.
- **Key domestic events and issues to watch:** Sep Mfg PMI, Aug unemployment rate (2 Oct); Aug PPI (3 Oct); Sep Services PMI, Aug retail sales (4 Oct); ECB minutes (5 Oct); Aug industrial production (12 Oct); Aug trade (16 Oct); Sep CPI, Oct ZEW Survey expectations (17 Oct); Aug construction output (18 Oct); Aug current account (20 Oct); Oct consumer confidence (23 Oct); Oct prelim PMIs (24 Oct); ECB meeting (26 Oct); 3Q GDP, Oct CPI (31 Oct).
- **Technical Outlook:** EUR corrected for the month of Sep, in line with our call for corrective play towards 1.1740. Intra-month low seen at 1.1717 (27 Sep); last seen at 1.1740 levels. Bearish momentum on weekly and daily chart remains intact. Weekly stochastics suggest that downside may have more to run but key support at 1.1680 (23.6% fibo retracement of 2017 low to high). Decisive move below that may trigger stop-sell orders and force a sharp move down to 1.1580 (100 DMA). Resistance at 1.1840 (50 DMA), 1.1900 (21 DMA) and 1.21 levels (life-time average).



GBP: Caught Between a Rock and a Hard Place

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
GBPUSD	1.3200 (1.3000)	1.3200 (1.2900)	1.3400 (1.3200)	1.3600 (--)

Previous Forecasts in Parenthesis

- Motivation for the FX View:** GBP traded sharply higher (>6%) over the past few weeks, hitting 15-month high of 1.3657 (20 Sep). This was in line with our call (in last month's FX outlook) for short term risks of rebound but the magnitude of the rise surprised us. The move higher was due to renewed expectations for BoE to tighten soon after (1) CPI rose to more than 5-year high; (2) house prices and PPI jumped; (3) sharp rebound in retail sales (2.8% y/y vs. 1.4% expectations); (4) unemployment rate slumped to more than 40-year low; (5) BoE MPC's hawkish comments.
- GBP could stay supported in the near term on the back of expectations for BoE to raise rates soon but we expect some of this GBP strength to fade as slowing growth momentum and ongoing Brexit uncertainties should counter GBP strength. Though BoE may raise rates as soon as upcoming meeting on 2 Nov or 14 Dec, we think the BoE is constrained to embark on tightening cycle as the central bank is trapped between a rock and a hard place. On one hand, BoE is running behind the curve in terms of tightening rates to arrest inflation (remains persistently above 2% inflation threshold for the past 7 months) amid tight labour market (unemployment rate at more than 40-year low) while on the other hand, BoE would have welcomed the luxury of time to keep rates low for longer to support growth momentum. That said we expect BoE to raise rates by 25bps this year, and it will be "one hike and done" instead of tightening cycle. This should see "buy on rumor, sell on fact" play on GBP.
- PM May's *Brexit* speech in Florence (22 Sep) offered some clarity. She proposed two-year transition period after Brexit Day (29 Mar 2019) and during this period, existing rules and market access stay the same and Britain will continue to pay into the EU until 2020 so that no members would lose out during EU's current budget round. She also made clear for the first time that Britain would "honour commitments it has made during the period of our membership", possibly opening the door to longer-term payments for projects extending well beyond Brexit. She also made concessions on citizens' rights, especially on the involvement of the European court of justice. She did not say what kind of Brexit she wants but what she doesn't want - a high-access but low-control arrangement like Norway's, or a low-access, high-control deal like Canada's. There seems to be some progress with the negotiations but remain too soon to be optimistic. The current stage of negotiation is still ongoing with the final round of the current stage scheduled on 9-Oct. We had shared that several issues such as Northern Ireland border and how regulations will function after

Brexit, status of European citizens living in the UK and UK citizens living in Europe need to be resolved by the first round, Oct-2017 (the scheduled timeline) before EU will commence negotiations on economic and trade relationships with the UK. There remains a risk that this timeline may be delayed. Disappointment with early optimism on progress with Brexit negotiations may weigh on GBP.

- We maintain our medium term (18 - 24month) bias that GBP could trade higher from current levels towards 1.38 - 1.44 as GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40). The 20% or so depreciation (from Jun to Oct 2016) should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We believe UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term). Past experience of UK leaving the ERM back in 1992 saw a period of consolidation (for a few years) at historical lows for GBP, before the eventual move higher in the following years, where GBP TWI traded above 100-levels in 1998 (from the lows of 80 in 1993-1996) due to buoyant demand fueled by rapid growth of wealth, credit and money. If history is a guide (assuming UK manages the transition well and takes the opportunity to correct its imbalances), its currency may start climbing higher.
- Taking into account recent market development (some progress with negotiations though timeline is likely to be delayed, BoE's shift in rhetoric preparing markets for rate hike, etc.) and calibrating for recent moves higher for GBP, we revised our GBP forecast slightly higher for 4Q-2017 to 2Q-2018 but kept forecast lower than where current spot is as we expect tactical USD rebound into year-end and possibly 1Q-2018.
- **Growth and Inflation Outlook:** UK manufacturing PMI unexpectedly accelerates to 4-month high of 56.9 in Aug (vs. 55.3 in Jul), with sub-component new orders seeing 13th consecutive month of expansion. Manufacturing accounts for nearly 1/10 of UK economy. Services PMI, though still in expansionary territory, fell to 11-month low of 53.2 in Aug (vs. 53.8 in Jul). Services sector account for about 80% of UK economy. Survey respondents noted that subdued client demand and heightened uncertainty about the domestic economic outlook weighed on business activity growth in Aug. Meanwhile Aug Construction PMI slowed to its lowest level of 51.1 in a year.
- We shared that the after-effects of *Brexit* appear to hit the UK economy with a 3-4 quarters "transmission lag". The UK economy expanded by +0.3% q/q for 2Q vs. +0.2% q/q for 1Q. Breakdown of the GDP by expenditure confirmed **household spending and business investment slowed** from previous quarter. Cumulatively for 1H, the data confirms that UK is in "notable slowdown" (according to Office for National Statistics) and this is consistent with our long-standing caution that UK growth momentum is slowing.
- Much uncertainty relating to whether London still hold as a financial hub, if investments inflows will slow and lead to weaker labor market or if jobs get relocated, remain unknown. Recent development saw

Nomura and Daiwa picking Frankfurt as its post-Brexit HQ and will move jobs out of London. Deutsche Bank is also considering moving 1/5 of its balance sheet from London to Frankfurt. JP Morgan, UBS and Goldman Sachs also mentioned moving staff out of London. Certainly these job losses have yet to materialise and may still be at early stages but eventually when consideration translates into decision, the pain will be felt and GBP is expected to bear the brunt of the painful *Brexit* consequences.

- **UK inflation jumped to highest level in more than 5 years in Aug, owing to the increase in prices of petrol and clothing.** Headline CPI for August picked up pace (0.6% mom vs -0.1% prior, 2.9% yoy vs 2.6% prior). Input PPI also came in better than expectations (1.6% mom vs 0% prior, 7.6% yoy vs 6.5% prior), while a similar story could be said for output PPI (0.4% mom vs 0.1% prior, 3.4% yoy vs 3.2% prior). Inflation is expected to stay above BoE's inflation target of 2% for longer than expected but we do not expect price pressures to stay near 3% for extended period as seasonal effects from travel (Easter holiday) and fuel prices ease while GBP stabilization after the sharp depreciation (post EU referendum in 2016) should stabilize import price pressures.
- **Monetary Policy Forecast:** We see rising likelihood of 25bps rate hike this year, as inflation remains stubbornly above BoE's 2% threshold. Most recently at the last BoE meeting, the MPC surprisingly struck a hawkish chord saying *"some withdrawal of monetary stimulus was likely to be appropriate over the coming months in order to return inflation sustainably to target"*. MPC also reiterated a warning from its Aug MPC meeting that *monetary policy could need to be tightened "by a somewhat greater extent" than market rates imply*. There is no MPC meeting scheduled for Oct. The two remaining meetings for this year are scheduled on 2 Nov and 14 Dec. Probability implied from UK OIS for rate hike those dates are at 70% and 75.6%, respectively. We believe even if BoE raises rate, it should be one and done and **not** a case of a tightening cycle as BoE is constrained from doing so due to decelerating growth momentum and ongoing *Brexit* uncertainties. Premature and aggressive tightening of monetary policy to arrest inflation may stifle growth momentum.
- At the last MPC meeting (14 Sep), BoE kept rate unchanged (MPC voted 7 -2) at 0.25% and maintained the stock of QE at GBP435b (unanimous vote from MPC). BoE Carney's speech at IMF (18 Oct) cautioned that **future UK interest rate increases would be slow in coming months and remain contingent on the UK economy performing to expectations**. He elaborated that modest monetary tightening is reinforced by the possibility that global r^* (equilibrium interest rates) and global inflation may be rising. This means monetary policy has to move in tandem in order to stand still.
- On the Aug Quarterly Inflation Report (or QIR), there were downward revisions to its macro assessment - economic growth from 1.9% to 1.7% for 2017 and from 1.7% to 1.6%; CPI projected to remain around 2.75% in coming months before falling back towards 2% target in 2018 while wage growth forecast was cut to 3% for 2018 (vs. 3.5% in May's QIR report). It also said that attempting to offset fully the effect of

weaker GBP on inflation would be achievable only at the expense of higher unemployment and in all likelihood, even weaker income growth. For this reason, the MPC's remit specifies that, in exceptional circumstances, the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity

- **Latest Fiscal and External Balance Outlook: UK public sector borrowing is at its lowest level since GFC.** Public sector net borrowing in August was £5.7bn, far better than market expectations of £7.1bn. For the financial year to date, from April to August, borrowing was £200m lower than the year before, at £28.3bn. This was the lowest amount for the five-month period since 2007 and the Government is currently on course to undershoot the Office for Budget Responsibility's forecast on borrowing. This gives Chancellor Hammond some room to ease austerity measures at the Nov Budget.
- Elsewhere, **Moody's cut UK rating (22 Sep) by 1 notch to Aa2** from Aa1, citing reasons relating to weaker public finances and fiscal pressures will be exacerbated by erosion of UK's medium term economic strength (due to UK leaving EU single market and customs union).
- UK's current account deficit to GDP narrowed further to -3.9% of GDP for 1Q 2017 from about -4.4% of GDP for 4Q 2016. Improvement was due to trade deficit narrowing (thanks to increase in exports amid softer GBP).
- **Key domestic events and issues to watch:** Sep Mfg PMI (2 Oct); Sep Construction PMI (3 Oct); Sep services PMI (4 Oct); Aug IP, construction output, trade (10 Oct); Sep CPI, PPI, RPI (17 Oct); Aug jobs report (18 Oct); Sep retail sales (19 Oct), Sep public finances (20 Oct); 3Q GDP (25 Oct).
- **Technical Outlook:** Our call for GBP rebound in our last FX Monthly (sent 31 Aug) was more than met. In fact the move was outside our expectation. GBP traded high of 1.3657 (20 Sep) before easing lower. Pair was last seen at 1.3330 levels. Daily momentum has turned bearish. Move lower may have more room to go on break below key support at 1.3320 (38.2% fibo retracement of Aug low to Sep high). Next support at 1.3220 (50% fibo) before 1.3130 (50 DMA). Resistance at 1.3450 (23.6% fibo), 1.3520. Bias for downside play.



AUD: Temporary Weakness; Maintain Positive Outlook

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
AUDUSD	0.78 (--)	0.80 (--)	0.81 (0.79)	0.83 (0.79)

Previous Forecasts in Parenthesis

- Motivation for the FX View:** AUD traded lower for the month of Sep amid persistent decline (>20%) in iron ore prices, slump in business confidence to 2-y low, China credit rating downgrade and re-escalation of geopolitical tensions (resulting of risk-off sentiment). The move lower is in line with our expectation (as mentioned in the last issue of FX Monthly), where we saw plausible correction in iron ore prices after the run-up for 3 consecutive months.
- Iron ore price correction since the start of Sep could be partially attributed to slowing demand from China (recent activity data saw a moderate slowdown) and China's clamp down on air pollution. It was understood that China is set to revoke 1,000 iron ore mining licenses (that is 1/3 of all mining licenses in China) mostly belonging to small polluting miners in its fight against pollution and outdated steelmaking capacity. These small miners will be forced to upgrade their production processes or face permanent closure. There are also talks that China could enforce environmental restrictions on steel production. These restrictions could suppress iron ore prices for the time being, and weigh on the AUD. We see support levels for the AUD at around 0.7820, 0.7730 and 0.7650 levels. We do not expect further decline to go beyond those support levels and look for opportunity to buy AUD on dips as Australia's macro fundamentals remain intact and are supportive of AUD strength. Synchronous recovery in global growth if sustained should also support risk sentiment and cyclical proxy plays such as AUD.
- Though there is little market expectation for RBA to tighten monetary policy for the time being, given slow pace of wage growth and concerns in household debt, we think an eventual shift in expectation should re-ignite demand for AUD. RBA Governor Lowe had said (21 Sep) somewhat hinted that rise in global interest rates would over time be expected to flow through to Australia. With US already in the midst of tightening interest rates (4 hikes so far and possibly one more in Dec-2017 and two more in 2018 - our house view), Canada also in the midst of tightening cycle (which started in Jul-2017 and has already raised rates by 50bps), UK could very likely be the next to follow. Furthermore, RBA expects Australia growth to average around 3% over the next few years and this will be slightly faster than the current estimate of trend growth and should lead to a gradual decline in employment rate, and pick-up in wages growth. This would tip RBA to possibly raise rate as early as in May-2018. Our recent study which takes into account monetary transmission lags and time take for

current and forecasted inflation to reach RBA inflation median target shows that RBA is slightly behind the curve in tightening. A combination of faster pick-up in wage growth, Australia inflation reaching its median target of 2.5% (range is 2 - 3%), steady economic growth in Australia, firmer commodity (base metals) prices amid synchronous recovery in global economy including China should lead to RBA tightening interest rate in due course. We revised our FX forecast higher from 2Q-2018 onwards to account for the above expectations.

- **Downside risk to our Outlook:** AUD may be subjected to further downside should there be persistent decline in iron ore prices arising out of slowdown in China growth. There is risk that ongoing deleveraging may affect the real economy, industrial profits while more property market cooling measures may weigh on construction activities and dampen demand for commodities or US tightens monetary policy more aggressive than what the Fed's dots plot implies (3 hikes in 2018).
- **Growth and Inflation Outlook: GDP growth rebounded to 0.8% q/q in 2Q** (vs. +0.3% in 1Q). Public sector was the main contributor with strong gains from public consumption and investment. Private consumption and business investment rose moderately while housing remains flat. On y/y basis, GDP growth remains unchanged at +1.8% for 2Q. Looking out RBA expects economic growth to continue to recover as drag from falling mining investments come to an end and the ramp-up in resource exports continue. Outlook for non-mining investment has improved and reported business conditions are at high level. RBA expects growth to average around 3% over the next few years. This will be slightly faster than the current estimate of trend growth and should lead to a gradual decline in employment rate, and pick-up in wages growth.
- **Next release of 3Q inflation is scheduled for 25 Oct.** 2Q headline inflation decelerated modestly to 1.9% (vs. 2.1% in 1Q). Core inflation showed signs of stabilization, with both weighted and trimmed mean at 1.8% in 2Q. Tradable inflation remains weak while non-tradable inflation continues to run at a higher rate than headline inflation. At the component level, food price inflation remains low and prices have declined for clothing and footwear, reflecting heightened retail competition. Entry of new foreign retailers including Amazon, is expected to constrain price pressures here. Stronger AUD, if sustained will also exert downside pressure on retail prices. Wage growth remains subdued and is expected to pick up gradually over the next few years. The central bank revised its headline inflation higher in its Statement on Monetary Policy from 1½-2½ % for year ended Jun 2018 that was seen in May this year to 1¾-2¾% this month. For much of the forecast period into Jun 2019, CPI is expected to lie between 2-3%.
- **Monetary Policy Forecast:** We continue to hold our view that RBA is likely to keep cash rate on hold at 1.5% for the next few meetings. While there has been plenty of comparison between Canada and Australia, Canada has seen a faster pace of real wage recovery than Australia. The stage of economic recovery is not comparable between two countries although RBA has been sounding optimistic. With

household debt at 190% of disposable income, a rise in rates could affect household consumption in an environment of low wage growth. A stronger AUD could also, still derail the recovery in the retail sales which has picked up pace to 3.8%/y (s/adj) from previous 3.1%, strongest pace seen since last Apr. Hence, while risks to rates seem to have tilted to the upside more recently, the AUD direction is more likely to be dictated by the USD, China's ability to maintain its growth stability, metal price swings and concomitant impact from its terms of trade.

- RBA kept cash rate unchanged at 1.5% as expected at its previous meeting (5 Sep). RBA made mention to AUD which has appreciated over recent months due to weaker USD. Stronger exchange rate is expected to contribute to the subdued price pressures in the economy and weigh on the outlook for output and employment. An appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation. RBA's Lowe shared in a speech (21 Sep) that a rise in global interest rates would over time be expected to flow through to Australia just as the lower interest rates have. He also mentioned about high household debt - higher levels of household debt change household spending patterns. Households are less inclined to let consumption growth run ahead of growth in incomes for too long if they had increased their borrowings. Higher level of debts also mean that household spending could be quite sensitive to increases in interest rates.
- **Latest Fiscal and External Balance Outlook:** Australia's current account deficit widened to A\$9.56 billion (s.a.) in 2Q. Lower export commodity prices for key exports of iron ore and coal were largely responsible for widening deficits.
- The 2017-18 budget deficit is A\$29.4bn and projected to return to a surplus of A\$7.4bn by 2020-21. Economic assumptions include inflation at 2% this year, real GDP of 2.75%. Total revenue is expected to be A\$444.4bn, up from A\$412.1bn in 2016-17. Net debt is projected to peak at 19.8% of GDP in 2018-19. Infrastructure spending will amount A\$75bn from 2017-18 to 2026-27.
- The budget managed to help the government avert a loss of its AAA rating by S&P. That said, the head of S&P Global Fixed Income Research Diane Vazza commented that there could be a rise in credit risk due to potentially ongoing budget deficits. Australia still has a negative credit rating outlook as its deficits run the risk of being persistent for several years with little improvement if the government is not able to implement more forceful fiscal policy decision. The situation is all the more weighed by the uncertain political climate where five of its lawmakers face a high court ruling on their fate to remain in parliament. That ruling (due in Oct) will determine whether the Liberal-National coalition can retain its one-seat majority in parliament and affect its ability to push through its policies.
- **Key domestic events and issues to watch:** Aug building approvals; RBA meeting (3 Oct); Aug retail sales, trade (5 Oct); Sep business confidence (10 Oct); Oct Westpac consumer confidence (11 Oct); Sep employment change (19 Oct); 3Q CPI, Export/Import Price index (25

Oct); 3Q PPI (27 Oct); Sep private sector credit, new home sales (31 Oct).

- Technical Outlook:** AUDUSD lower for the month of Sep. Last seen at 0.7810 levels. Bearish momentum on weekly and daily chart remains intact while stochastics is falling. Sustained close below 0.7820 (38.2% fibo retracement of May low to Sep high) could see AUD dip to 0.7770 (100 DMA), 0.7730 (50% fibo). Resistance at 0.7940 (50DMA, 23.6% fibo). Cautious of downside risks but bias to buy on dips.



NZD: Election and Policy Uncertainty to Weigh

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
NZDUSD	0.7300 (0.7400)	0.7400 (0.7500)	0.7500 (0.7600)	0.7600 (--)

Previous Forecasts in Parenthesis

- Motivation for the FX View:** We maintain our call for NZD to remain on a back foot as (1) election outcome uncertainty casts doubts on government policy continuity on immigration and trade; (2) inflation is likely to decline in coming quarters as base effects of higher fuel and food prices wears off. Outlook for tradables inflation remains soft while non-tradables inflation remains moderate; and (3) RBNZ likely to stand pat on monetary policy as there is no urgency to tighten while US is expected to tighten resulting in policy divergence growing (yield differentials between NZ and UST could narrow moderately); seasonality trends suggest 4Q is typically a bearish quarter for the NZD. We see risk of NZD trading lower towards 0.71, 0.70 levels in coming weeks especially if coalition government is made up of the three parties - Labour, Green and NZ First. We revised NZD forecast 1 cent lower across the forecast horizon to take into account the change in single party government to coalition government, which we see downside risks to NZ macro-fundamentals due to potential shifts in policies relating to immigration and trade. We could potentially revise the forecast further if the coalition government is made up of Labour, Green and NZ First parties.
- As of writing, NZ election results were inconclusive for any party to form a government. National party (the ruling party) secured 58 seats; Labour party secured 45 seats; Labour's ally Green secured 7 seats while NZ First party secured 9 seats. Though national won the most seats amongst the parties, they are short of the 61 seats (out of 120 seats in parliament) required to form a majority. A final tally including overseas votes and those who voted outside their home constituencies will be released on 7 Oct. Going by past trends, National tends to lose a seat while the Green party tends to gain a seat (the final tally may favour Labour-Green coalition more than National but should not materially change the outcome).

- NZ First party holds the balance of power to form the government with either National or Labour-Green coalition. It is not clear which party NZ First's leader Winston Peters favours and how soon he will arrive at a decision though he did tell press that he will decide by 12 Oct.
 - A grand coalition involving Labour, Green and NZ First will likely point to a more inward looking, nationalist-focused agenda. On trade, Labour party's leader Jacinda Ardern had already made her stance that she wants a renegotiation of the TPP and other FTAs (with China and Korea) to ban foreign ownership of existing homes. This could lead to a slowdown in foreign investment inflows into NZ and the NZD may bear the brunt of the outcome. On immigration, Labour has promised to reduce net immigration by up to 30,000 per year (that's nearly half of the annual net migration of 72,400 in the Jul 2017 year) while NZ First party had previously campaigned to reduce net migration to around 10,000 per year. This scenario is not impossible and should bode ill for NZD.
 - A coalition government involving National and NZ First is less negative on NZD outlook as National party is known to pursue an outward-looking trade policy and is perceived to be business-friendly. But differing views between National and First Party on immigration policies may cloud NZD outlook. This scenario may see 1 - 2% relief rally in NZD.
- This period of waiting before the next government is formed should cast some uncertainty and bring about heightened volatility. Our previous NZD forecast took into consideration the risk of election outcome uncertainty hence our slightly more bearish-than-consensus NZD forecast for 3Q 2017 at 0.71. As of writing (26 Sep), NZD had declined by about 2% post-election results and was last seen at 0.72 levels. We will review our NZD forecast and outlook depending on which coalition takes power. We reiterate that National/NZ First coalition is less negative on NZD outlook but a grand coalition (Labour/Green and NZ First) should imply more negativity on NZD outlook.
- Taking stock of the past month, our caution that NZ General Election posed some degree of uncertainty, NZ political risk premium is under-priced and that NZD may be biased to the downside panned out well. NZD traded a high of 0.7433 (20 Sep) prior to election. Price action somewhat suggested that markets were complacent about the elections outcome, expecting National party to win. But subsequently declined to post-election low of 0.7196.
- **Growth and Inflation Outlook: 2Q GDP rose 0.8% q/q (vs. +0.6% in 1Q)**, largely due to one-off boost from tourism (British and Irish Lions rugby tour and World Masters' Games) and rebound in agriculture and transport. Export of good & services surged 5.2%, led by strong diary shipments while construction activity fell for a second straight quarter. On y/y basis, GDP remained unchanged at 2.5% in 2Q 2017.
- NZ's economy is expected to continue growing at an average of 3.1% over the next 4 years, according to last RBNZ Monetary Policy

Statement (10 Aug) - this may change as some of the previous pillars supporting the economy - tourism, immigration may change as a result of change in government. While election outcome is inconclusive at time of writing, we are cautious of NZ's outlook, especially if a coalition is formed between Labour, Green and NZ First parties as this combination suggests a more inward looking and nationalist-focused agenda. New policies may be less positive on immigration, trade and foreign investments. On immigration, Labour has promised to reduce net immigration by up to 30,000 per year (that's nearly half of the annual net migration of 72,400 in the Jul 2017 year) while NZ First party had previously campaigned to reduce net migration to around 10,000 per year. On trade, Labour party's leader Jacinda Ardern had already made her stance that she wants a renegotiation of the TPP and other FTAs (with China and Korea) to ban foreign ownership of existing homes.

- **RBNZ expects headline inflation to decline in coming quarters** as effects of higher fuel and food prices wears off. Outlook for tradables inflation remains soft while non-tradables inflation remains moderate. Longer term inflation expectations remain well anchored at around 2%. Our inflation forecast sees NZ inflation falling towards 1Q 2018 before rebounding.
- **Next release of 3Q inflation data is scheduled for 17 Oct.** 2Q CPI slowed to 0% q/q from 1% in 1Q, owing to decline in fuel costs and airfares, telecommunication products and services. On y/y basis, 2Q CPI moderated to 1.7% (vs. 2.2% in 1Q). A stronger Kiwi over the past few months may also have dampened tradables inflation (0.9% at 2Q 2017). The softer than expected print should dampen market speculation for earlier than expected rate hike and remains consistent with RBNZ Wheeler's earlier comments that the spike in 1Q inflation is likely to be temporary and may lead to some variability in headline inflation. Non-tradables inflation has been running around 2.4%, persistently below the average levels, reflecting weak price setting behaviour while a key driver holding up non-tradables inflation was housing-related items (Auckland construction cost inflation was around 8% and around 5% of areas outside Auckland). RBNZ expects non-tradables inflation to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range over the medium term Core inflation (stripping volatile food and energy prices) was slightly softer at 1.4% (vs. 1.5% between 4Q-2015 and 1Q 2017). This is consistent with subdued domestic inflationary pressures.
- **Monetary Policy Forecast:** We expect RBNZ to keep OCR on hold at record low of 1.75% at the upcoming meeting (9 Nov) and possibly for the next 6 months. Accompanying monetary policy statement is likely to remain "neutral" and flag the risks of slowing growth momentum and core inflation in coming quarters. RBNZ should also welcome the recent 3.5% decline in NZ TWI from above 79-levels to 76.20 levels (as of writing). Grant Spencer has taken over Graeme Wheeler (effectively 27 Sep) as acting Governor for 6 months before he goes into retirement. This 6-months period may see monetary policy remain status quo till Mar-2018 unless inflation overshoots upper band of target range of 3% (not our base case scenario). A coalition

government with NZ First may see the risk of NZ First pursuing its promises to reform the Reserve Bank Act and regain sovereignty over banking and financial services. In particular NZ First sought to replace inflation-targeted monetary policy with Singapore S\$NEER model

- At the last RBNZ meeting (28 Sep), RBNZ kept OCR on hold at record low of 1.75%. Accompanying statement acknowledged the rebound in 2Q GDP following relative weakness in previous two quarters and expect growth to maintain its current pace going forward supported by accommodative monetary policy, strong population growth (we are sceptical given the potential change in government policy towards immigration), high terms of trade and fiscal stimulus. **The trade-weighted exchange rate has eased slightly since the August Statement. A lower New Zealand dollar would help to increase tradables inflation and deliver more balanced growth.** House price inflation continues to moderate due to loan-to-value ratio restrictions, affordability constraints, and a tightening in credit conditions. This moderation is expected to continue, although there remains a risk of resurgence in prices given population growth and resource constraints in the construction sector. Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly
- **Latest Fiscal and External Balance Outlook:** The Treasury will release government financial statements for year ended Jun-2017 on 5 Oct. OBEGAL is forecast to show a surplus of \$3.7bn (vs. \$1.6bn) for the 12-months ending Jun-2017 thanks to strong tax returns. Core Crown tax revenue expected to grow by 7.4% compared to an increase of around 4% in core Crown expenses. While the 2016/17 fiscal results are estimated to be better than previously forecast, the OBEGAL forecasts for the next four years remain fairly close to the Budget Update.
- In NZ budget previously announced before the election, the government plans to raise tax thresholds, increase accommodation payments and adjust family tax credits. **Though the package will cost \$6.5bn over 4 years and is expected to eat into budget surpluses, the package is expected to boost spending. The package will result in a modest increase in inflationary pressure and earlier monetary tightening.** Net debt is projected to decline to 19.3% of GDP by 2021 from 23.2% this year. A target of reducing debt to 10-15% of GDP by 2025 has also been set.
- 2Q current account deficit narrowed to NZ\$7.49bn or -2.8% of GDP (vs. -3.1% in 1Q). The improvement was due to Foreign sports fans travelling to NZ for World Masters Games (Apr) and British and Irish Lions rugby team (Jun).
- **Key domestic events and issues to watch:** Sep Commodity prices (4 Oct); Government publishes 12-month financial statements (5 Oct); Sep food prices (12 Oct); Sep Mfg PMI (13 Oct); Sep Performance Services index (16 Oct); 3Q CPI (17 Oct); Sep net migration (20 Oct); Sep trade (26 Oct); Oct Business confidence (31 Oct).

Technical Outlook: NZD continued to trade lower for the month of Sep, in line with our bias to lean against strength. Pair was last seen

at 0.7170 levels. Bearish momentum on weekly and daily chart remains intact while stochastics indicators are falling. We are bearish bias on NZD. Sustained close below 0.7190 (neckline of head and shoulders pattern) should see further downside play gather momentum towards 0.7140 levels (200 DMA), 0.71 (61.8% fibo retracement of May low to Jul high). Resistance at 0.7250 (21, 100 DMAs), 0.7280 (38.2% fibo). Stay short.



JPY: Monetary Divergence Back In Play

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDJPY	115 (--)	115 (--)	117 (--)	116 (--)

No Change to Previous Forecasts

- Motivation for the FX View:** The USDJPY slipped to a new low 107.32 on 8 Sep amid geopolitical tensions over North Korea. The USDJPY though has since rebounded to a near two month high of 113.26 on 27 Sep. This underperformance of the JPY in Sep, where it has slipped 2.25% against the USD, makes it the worst performing currency among the currencies we track. This move has resulting in the JPY giving up most of its gains this year, gaining just 3.96% against the USD in the first nine months of the year. It is no longer among the best performing currencies among the Asians, outperforming just the IDR and the PHP. We maintain our bearish call on the JPY.
- CFTC data still points to further JPY weakness ahead.** After paring of some short positions in the two weeks prior, market has increased their net short-JPY positions as of the week of 26 Sep. Speculators has increased their short-JPY positions (114310) more than their increase in long-JPY bets (42963). This has resulted in a net increase in JPY short contracts of 71347 as of the week of 26 Sep. The rise in net short contracts suggested markets remained convinced of further JPY weakness particularly in the wake of another Fed rate hike in Dec (as we had cautioned previously) and progress in US tax reforms. Together, these should lift UST yields higher with JGB at least holding steady around current levels, leading to further increases in net short-JPY bets and hence, more upside to the USDJPY in the remainder of 2017 and into 2018.
- Underpinning this view for further JPY weakness against the USD,** albeit at a more gradual pace, is the central bank's ongoing ultra-loose monetary policy. Unlike its G7 peers, there does not appear to be any end in sight to this easing policy. In fact, the dissent by new board member Goushi Kataoka, arguing that the current policy was not enough to achieve the 2% inflation target, suggest that the policy bias ahead could tilt towards more easing measures than a tapering/unwinding. Even BPJ governor Kuroda reiterated that the

central bank will “tenaciously” keep up powerful easing. This underlying powerful easing should be supportive of the USDJPY.

- Though BOJ board member Kataoka could be laying the groundworks for further easing measures, such moves are unlikely for now. This is especially given that the economy is on a steady recovery path. Still, should inflation fail to gain traction going into 2018, we cannot discount the BOJ unleashing even more easing measures to lift inflation towards the BOJ’s 2% target. These easing measures could include cutting interest rate further to -0.3% (from -0.1% currently) and increasing asset purchases of ETFs and J-REITs and other instruments to JPY10tn and JPY6tn.
- Safe-haven plays have led to recent weakness in Japanese equities for most of Sep. This is despite the weak JPY since 2013 having boosted earnings of Japanese firms and their stocks. Instead, concerns about the prospects of war on the Korean peninsula led to the sell-off in equities by foreign investors and the purchase of government debt. Consequently, foreign investors had sold off JPY2.49tn in equities in Sep. In contrast, they had sold off JPY5.67tn in equities for the whole of 2016. Still, the stock market is recovering after the recent bout of selling with the Nikkei 225 index back above the 20,000 levels at 20356 as at end-Sep as geopolitical tensions fade.
- Further inflows into equities could see the index climb within striking distance of the multi-year high of 20,868 (24 Jun 2015) and lift the USDJPY higher. This is because of the strong positive correlation between the Nikkei 225 Index and the USDJPY. Foreign investors usually hedge their equity purchases against further JPY depreciation by short-selling the JPY. Thus, improvement in global sentiment amid low volatility should encourage even more inflows into Japanese equities and provide even more upside to the USDJPY. We caution though the possibility of intermittent JPY strength due to global risk-off episodes especially in an environment of exceptional low volatility, but these should eventually subside. We do not expect such episodes to hamper further depreciation of the JPY against the USD.
- We maintain our USDJPY forecast for now. We continue to project the pair to climb higher to end the year at 115 and then to hover around this level in 1Q 2018. We expect US reflection trade in 2H 2017 to lift the USDJPY higher with the pair ending 2Q-2018 at 117 before easing slightly to 116 by end-3Q 2018.
- **Growth and Inflation Outlook:** The economy continues to strengthen as reflected in the recent GDP print for 2Q 2017. Preliminary 2Q17 GDP showed the economy expanding for a sixth straight quarter by a better-than-expected 4.0% q/q annualised in 2Q (1Q: +1.5%). Market had expected growth of just 2.5%. Stronger domestic demand (+5.2% q/q annualised), including private consumption, was the main driver of growth in the quarter. This helped to completely mitigate the weakness in the external sector, where exports have fallen 1.9% q/q annualised. There could be further upside to manufacturing activities should the synchronized recovery in exports be sustained. Exports have risen by 13.4% y/y in Jul, an improvement over Jun’s 9.7% and 2Q’s 10.7%. That said, the BOJ governor does not expect this growth pace to be sustainable and expects growth to moderate to around 2%.

BOJ expects the economy to expand by 1.8% in FY2017 and for the economy to expand by 1.4% in FY2018.

- Inflation is creeping higher with headline inflation rose 0.7% y/y in Aug vs. 0.4% in Jun and consensus' 0.6%. Core and Core-core inflation also bounced higher, rising 0.7% (cons.: 0.7%) and 0.2% y/y (cons.: 0.2%) in Aug. These were an improvement from Jul's 0.5% and 0.1% respectively. The slow progress on the inflationary front is not surprising given that there has been no significant pick-up in wage growth (with growth in base wages, i.e. excluding OT and bonuses, hovering just around the 0.5% for the past few months) despite the improved domestic economic conditions, including the tightening labour market. The persistently low inflationary environment suggests that the powerful easing by the BOJ will continue for the foreseeable future. This is in contrast with its US and EU peers who are either looking or beginning to unwind their QE programmes. This should hopefully allow the BOJ 2% inflation target to be achieved around FY2019, i.e. fiscal year starting Apr 2019 to Mar 2020. The BOJ continues to forecast core CPI to average 1.1% and 1.5% respectively for FY2017 and FY2018.
- **Monetary Policy Forecast:** The BOJ maintained its ultra-easy policy stance at its policy meeting on 21 Sep, keeping its policy balance (short-term) rate at -0.1% and 10Y JGB yield target at around 0%. There was also no "u-turn" from its asset purchase program even though this measure is no longer central to its "QQE with Yield Curve Control" regime. At the post-meeting press conference, the governor again reiterated the central bank will "tenaciously" keep up powerful easing. The only surprise from the meeting was the dissenting vote from new board member Goushi Kataoka who argued that the current policy was not enough to achieve the 2% inflation target. Kataoka could be laying the ground for even more easing measures should inflation continue to gain traction. That said, it would appear that there is no turning back from the ultra-loose monetary policy for the foreseeable future. This is in contrast to its G7 peers, who are either considering (ECB and BOE) or already withdrawing monetary stimulus (Fed and Bank of Canada), amplifying the divergence in monetary policy.
- So far, BOJ's monthly bond purchases show no hints of QE tapering. For the fourth consecutive month, the BOJ has left its planned range for bond purchases unchanged. Intra-month though the BOJ can reduce the amount of bonds it purchases within its planned purchase range for the month so long as yields allow. The BOJ has yet to formally taper its asset purchases and is unlikely to do so until its inflation target is achieved. For Sep, the BOJ intends to purchase on JPY50-150bn for debt up to 1 year maturity, JPY200-300bn for 1-3 year maturity, JPY250-350bn for 3-5 year, JPY300-500bn for 5-10 year, JPY150-250 for 10-25 year and JPY50-150bn for more than 25 year maturity.
- Despite the dissenting view from board member Kataoka, we doubt that additional easing measures will be forthcoming. Still, cannot rule out such moves completely. In an environment of muted inflation, the central bank could be prompted into action, unleashing even more

easing measures to lift inflation towards the BOJ's 2% target. These easing measures could include cutting interest rate further to -0.3% (from -0.1% currently) or even surprise with a change in regime.

- The BOJ could also face complications in its future policy decision making should the government decide to postpone its goal of achieving a primary balance/surplus by 2020 if it calls for a snap election and moves ahead with a sales tax hike in 2019. The delay in fiscal consolidation complicates matter for the BOJ as it does not want to be seen as monetizing government debt. It is unlikely that the BOJ will “u-turn” from its current ultra-easy monetary easing given that the BOJ policy board is now stacked with policy doves. Nevertheless, the call for an unwinding of BOJ asset purchases could intensify though and there could be increasing pressure to deal with its own tapering sooner than it would like. Any moves that hint of tapering is likely to increase uncertainty, leading to a sell-off in domestic equities and increased JGB purchases, and weigh on the USDJPY.
- **Latest Fiscal and External Balance Outlook:** PM Abe is planning to move ahead with implementing the consumption sales tax hike as part of his election manifesto should he call for snap elections. The move to raise the sales tax to 10% from 8% was set to be implemented in Oct 2019. Already this tax hike has been postponed twice in 2014 and 2016 ahead of elections. There is little excuse for postponing the sales tax hike as the economy is strong enough (having expanded for six straight quarters) to withstand a hike. Of concern though is the possibility that the government could delay its goal of achieving a primary balance/surplus in 2020 and also divert revenue from the sales tax hike to other uses like education and support for young families instead of reducing the deficit.
- After narrowing for the past three months, the current account (CA) surplus widened in Jul. The CA surplus rose JPY2.32tn in Jul from JPY0.93tn in Jun due to the rebound in the primary income account surplus of JPY2.15tn (vs. Jun's JPY0.51tn) offsetting the moderation in the goods and services surplus. The goods and services surplus moderated to JPY0.33tn in Jul from Jun's JPY0.47tn due to the wider deficit in the services account. The financial account surplus narrowed again in Jul to JPY0.85tn from JPY1.34tn in Jun as the wider deficit in the other investment account (Jul: JPY7.07tn vs. Jun: JPY1.17tn) offset the improvement in the portfolio investment account (Jul: JPY6.33tn vs. Jun: JPY1.17tn). Despite the wider CA surplus, the overall balance of payments (BoP) surplus narrowed for the second straight month to JPY1.71tn in Jul from JPY2.69tn in Jun. Aside from the narrower surplus in the financial account, the jump in net errors and omissions to JPY1.45tn in Jul (Jun: JPY0.42tn) was a drag on the overall balance of payments.
- **Key domestic events and issues to watch:** The 3Q Tankan Survey result will be released on 2 Oct. BOJ governor Kuroda will speak on 20 Oct in Tokyo. We have BOJ meeting on 30-31 Oct to decide on monetary policy, followed by BOJ governor Kuroda's press conference. At the same time, the BOJ will release its outlook report for the economy. On the political front, a snap election for the Lower House

of the Diet will be held on 22 Oct to secure for PM Abe a historic third term as prime minister. JGB auctions in Oct: 10-year (3 Oct), 30-year (11 Oct), 5-year (19 Oct), 1-year (18 Oct) and 20-year (17 Oct).

- **Technical Outlook:** Our bias to buy on dips, as per FX Monthly sent 31 Aug worked well. USDJPY traded a high of 113.26 (27 Sep); last seen at 113 levels. Bullish momentum on weekly and daily chart remains intact. We see room for more upside play towards 114.50 (Nov low to Dec-2016 high). Support at 112 (38.2% fibo, 200 DMA). Bias to stay long.



CNY: Of National Congress, Trump's Visit and Stable CNY

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDCNY	6.60 (--)	6.60 (6.63)	6.65 (6.58)	6.60 (--)
USDCNH	6.60 (--)	6.60 (6.63)	6.65 (6.58)	6.60 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The sharp decline in USDCNY to 21-month low of 6.4390 (8 Sep) was met with sharper rebound amid policymakers' concerns about the pace of Renminbi gains, relaxation of reserve requirement for FX forward purchases and offshore RMB deposits, activity data losing momentum and persistent decline in iron ore prices since early Sep. USDCNY subsequently traded higher for the month of Sep, closing at 6.6528. For the coming weeks, we expect some variability with CNY, possibly facing some downside pressure (vs. USD) weighed by iron ore prices but CNY to maintain relative stability against its basket of currencies (CFETS index around 94 - 95 levels; USDCNY possibly in 6.60 - 6.72) into the 19th National Congress of the Communist Party of China (starts on 18th Oct). We see risks of CNY strength (towards 6.55 vs. USD) into month-end ahead of Trump's visit to China (3 Nov) and US Treasury Report to Congress (likely to be end-Oct).
- On 8th Sep, PBoC removed reserve requirements for FX forward purchases and on offshore RMB deposits placed with onshore agent banks. These measures were previously introduced in 2015 to increase the cost of shorting CNY and served to counter strong outflow pressures at that time. Given the recent 5% appreciation in Renminbi (since mid-Jul), it is thought that policy makers may be less concerned with outflow pressures (as compared to the past) and the depreciation pressure on RMB may have diminished from PBoC's perspective. Relaxation of policies suggests that RMB may transit towards more flexible regime with greater 2-way volatility and to allow markets to participate in hedging. At the same time on 8th Sep, local media reported that policymakers were concerned about the pace of RMB gains. We shared that such comments and the relaxation

of Reserve requirements could be timely for an interim base for USDCNY at around 6.45 levels.

- Iron ore price correction since the start of Sep could be partially attributed to slowing demand from China (recent activity data saw a moderate slowdown) and China's clamp down on air pollution. It was understood that China is set to revoke 1,000 iron ore mining licenses (that is 1/3 of all mining licenses in China) mostly belonging to small polluting miners in its fight against pollution and outdated steelmaking capacity. These small miners will be forced to upgrade their production processes or face permanent closure. There are also talks that China could enforce environmental restrictions on steel production. These restrictions could suppress iron ore prices, activity growth and weigh on CNY for the time being.
- Looking ahead, there are a handful of events coming up over the next few weeks including (1) China's 19th National Congress starting 18 Oct; (2) bi-annual US Treasury report to Congress, which outlines the currency practices of US's major trading partners (likely to be end-Oct) and (3) Trump's 5-day visit to Asia including China (3 Nov).
 - 19th National Congress of the Communist Party of China (十九 大) begins on 18th Oct and is expected to last 7 - 8 days. Main focus on leadership changes in the Politburo Standing Committee (PSC). Two of the seven members that will remain on the PSC are President Xi Jinping and Premier Li Keqiang. Five out of seven members are expected to retire (due to age ceiling of 67 years). That are talks that Wang Qishan (heads the anti-graft campaign and widely seen as a strong ally of President Xi) could potentially serve another term despite turning 69 years old next year because of his anti-graft achievements and economic acumen. If he stays on, President Xi would be setting a precedent which would help Xi consolidate his powers further. We also expect some focus on SOE reforms (potentially pushing for SOE M&A in key sectors including telecoms, energy, manufacturing, etc. Given recent focus on encouraging inclusive financing for small businesses, there may be business-friendly measures (i.e. tax incentives) to support SMEs. There are also some expectations that PBOC could widen the trading band from +/-2% to +/-3% to demonstrate more symbolic commitment towards yuan liberalization. On RMB policy, it is clear that PBoC will continue to be cautious and pragmatic to pursue relative stability this month. The RRR cut (announced 30 Sep) was not a shift in monetary policy but a structural adjustment to encourage inclusive financing at commercial banks. We expect PBoC to keep monetary policy "prudent and neutral", and continue to focus on influencing funding rates by managing RMB supply.
 - Banks with more than 1.5% of their loans extended to small business would see their RRR cut by 50bps while banks with at least 10% of their loans to small businesses would see their RRR cut by an additional 100bps.
 - The last Treasury report released in Apr-2017 confirmed that China will not be named a currency manipulator and we do not expect any surprise in the upcoming release especially

when the RMB had appreciated more than 4% (vs. USD) and more than 7% at one point (YTD 8 Sep). Though we acknowledge there could still be some risks especially when China's trade surplus with US rose to US\$26.2bn, its highest level in nearly 2 years.

- Trump's visit to China (3 Nov) is likely to see topics on North Korea and reiterating strong US-China relations take center-stage. Trump's visit to the region will include stopovers in Japan, South Korea, Vietnam and the Philippines.
- In terms of FX forecast, we made some minor calibration, lowering 1Q forecasts as we expect EUR strength to keep CNY supported and raising 2Q forecast slightly to account for potential USD strength owing to US tax reform plans getting enacted.
- **Our monthly Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) showed a deterioration for China to 5.3 from previous 5.2 (with 1 being the best and 9 being the worst) as its scores for FX reserves deteriorated compared to regional peers.
- **Growth and inflation outlook: Official PMI numbers came in strong for Sep.** Manufacturing PMI rose to 52.4, its highest print since Apr 2012. New order, production, new export orders, input & output price sub-indices all rose. **Official non-manufacturing PMI jumped to its highest level (55.4) since May 2014.** Its sub-components services and construction PMIs both strengthened. As of writing, Caixin PMIs (for SMEs) for Sep have yet to be published. Activity data, on the other hand, slowed in Aug (vs. Jul). Industrial production +6% y/y (vs. 6.4% prior); retail sales +10.1% y/y (vs. 10.4% prior) and FAI slowed to +7.8% (vs. 8.3% prior). Slowdown in momentum can be attributed to China's intense clampdown on air pollution and slower retail sales shown in housing related white goods (possibly reflecting slower home sales).
- **Both CPI and PPI accelerated in Aug.** Headline CPI rose to 1.8% y/y (1.4%), helped by rebound in food inflation while non-food inflation continues to stay relatively stable. PPI rose to 6.3% y/y (vs. 5.3% prior) and the increase came mainly from smelting and pressing of ferrous metal and non-ferrous metal, petroleum industries, non-metallic products and chemical materials. Further increase in food and energy prices should see further upside in CPI while the clampdown in air pollution may limit the upside for PPI.
- **Monetary Policy Forecast:** We expect PBoC to keep monetary policy "prudent and neutral", and continue to focus on influencing funding rates by managing RMB supply. On RMB policy, it is clear that PBoC will continue to be cautious and pragmatic to pursue relative stability via the use of its daily fixing mechanism which has been rather successful in guiding and managing FX. There are also some expectations that PBOC could widen the trading band from +/-2% to +/-3% to demonstrate more symbolic commitment towards yuan liberalization.
- The recent targeted Reserve Requirement Ratio (RRR) cut was not a shift in monetary policy but a structural adjustment as it aims to encourage inclusive financing at commercial banks such as providing credit support for small and micro-sized enterprises, start-ups and

agricultural production. Banks with more than 1.5% of their loans extended to small business would see their RRR cut by 50bps while banks with at least 10% of their loans to small businesses would see their RRR cut by an additional 100bps. This will be effective 2018. The move is estimated to release about CNY600-800bn of liquidity into the system. Current RRR stands at 17%.

- **Latest Fiscal and External Balance Outlook:** The Ministry of Finance stated that fiscal revenue rose 11.1%y/y to CNY1.65trn in Jul. PBOC had stated that China will coordinate fiscal and monetary policy. In addition, Vice Finance Minister Liu Wei suggested tax breaks to ease funding cost in real economy. So while real rates could rise and PBOC can continue to tighten, the government may be able to offset the rise in funding cost by offering tax breaks.
- Current account surplus widened to U\$52.9bn in 2Q from previous U\$18.4bn due to a wider goods trade balance (U\$133.2bn) that more than offsets the slightly wider deficit in services deficit (U\$74.4bn). BOP (other investment) recorded an inflow for the first quarter of the year though that was offset by outflows recorded in the portfolio investment and direct investment. Still, it is noteworthy for currency and deposits to record a positive net inflow of U\$49.4bn and trade credit of U\$12.4bn. FX reserves saw another mild increase in Jul, likely due to valuation to U\$3080.7bn from previous U\$3056.8bn. This is due to strong capital controls, sluggish USD and an increasing bullish view of the CNY.
- **Key domestic events and issues to watch:** China is out for golden week from 1 to 7 Oct; onshore markets will return on 9 Oct. FX reserves (8 Oct); Caixin PMI (9 Oct); trade (13 Oct), CPI, PPI (16 Oct), Money supply M2, new yuan loans and aggregate financing (between 10 and 18 Oct); 3Q GDP, Sep Retail sales, FAI, industrial production on (19 Oct); Property prices (23 Oct); Industrial profits (27 Oct); Oct NBS PMIs (31 Oct).
- **Technical Outlook:** USDCNH rebounded sharply in the month of Sep. Last seen at 6.6750 levels. Bullish momentum on daily chart remains intact while bearish momentum on weekly chart is fast waning. Technical signals suggest risk of further rebound possibly towards 6.72 levels (100 DMA). Support at 6.6520 (38.2% fibo retracement of 2017 high to low) before 6.6380 (50 DMA).



KRW: Losing Appeal

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDKRW	1160 (--)	1140 (1170)	1140 (1180)	1130 (--)

Previous Forecast in Parenthesis

- Motivation for the FX View:** Our caution (in previous issue of FX Monthly) for USDKRW to face some upside risks for 2H Sep panned out. Pair traded a low of 1119 in early-Sep before inching higher towards 1140 (27 Sep). The move higher came amid USD strength and higher USD yields as markets' re-price Fed's path of monetary tightening. On-off re-escalation of geopolitical tensions also kept the pair supported.
- We continue to see **upside risks for USDKRW over the next few weeks** on a combination of external and domestic drivers: (1) ongoing on-off geopolitical tensions should weigh on investor sentiment and reduce the appeal of Korean assets (net foreign inflow to Korean equity have already started to decline since end-Jul while net foreign inflow to Korean bonds have plateaued) and KRW; (2) inbound tourism may also come under pressure (inbound foreign tourists to Korea -35% y/y in Aug) as a result of on-off geopolitical tensions; (3) potential for sustained tactical rebound in USD and UST yields arising out of Fed remains on path of tightening (resulting in markets re-pricing expectation) and rising likelihood that US may be getting their act on tax reforms while BoK is expected to keep monetary policy accommodative (resulting in policy divergence); (4) poor China-Korea relations which still show no signs of improvement after Korea approves additional deployment of THAAD (Inbound Chinese tourists to S. Korea has fallen 70% yoy in Jul); (5) US's determination to re-negotiate or terminate its FTA with S.Korea may hurt Korean businesses, exports and these would have negative repercussion on KRW. We see support for USDKRW around 1120 while the pair may trade higher towards 1155 next month.
- On-off geopolitical tension continued. Apart from North Korean firing another missile (15 Sep) over Hokkaido for second time in two months, Trump and Kim also engaged in fresh round of war of words. North Korea's Kim responded to Trump calling him "mentally deranged" and threatened to take the "highest level of hard-line countermeasure in history" (22 Sep). This was the first time Kim has made a direct statement. According to media, such highest-level countermeasures could include the detonation of hydrogen bomb in the Pacific (citing Foreign Minister Ri Yong Ho). Trump had ordered new sanctions on individuals, companies and banks doing business with North Korea (21 Sep). On 25th Sep, North Korea Foreign Minister Ri Yong Ho described Trump's recent comments as declaration of war

and it is within rights for them to shoot down US bombers even if they don't cross into the isolated nation's airspace. Trump fired back saying he is prepared to take 'devastating' military actions against North Korea (26 Sep). Such on-off geopolitical tensions do not bode well for investor sentiment and tourism. We see this weighing on Korean assets and KRW in the near term.

- Not all is down and out for KRW; there are mitigating factors against KRW negativity. Synchronous recovery in global growth and robust trade recovery in Asia, including Korea (+31.1% yoy in first 20 days of Sep) should benefit Asian currencies including KRW. Supported risk sentiment should also support high-beta proxy play such as KRW. Near term downside pressure on KRW should also dissipate over time (assuming no outright military conflict in Korea peninsula) allowing investor sentiment and confidence to recover. As such as revised our 2Q and 3Q 2018 USDKRW forecast lower but maintain 4Q 2017 and 1Q 2018 forecast on factors abovementioned - USD tactical rebound, on-off geopolitical tensions, poor relations between China and Korea as well as risk of KORUS being terminated.
- We revised 1H 2018 forecast lower for USDKRW to take into account the possibility of BoK rate hike in 1H 2018. We see risk for a 25bps hike in possibly as early as 1Q 2018 if growth momentum picks up further owing to supplementary budget and results in demand-pull inflation.
- **Downside Risks to Our Outlook:** USDKRW may trade lower or break below our expected support level should the case for global policy unwind proceed at an even moderate pace than gradual - such as a situation whereby Fed does not tighten monetary policies at the Dec FOMC meeting while macro environment of low vols, generally subdued inflation, global growth rebound and synchronized trade recovery in the region gathers pace. This should favor risk on appetite and fuel further gains in the KRW.
- **Our monthly Maybank Vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for S.Korea improved modestly to 6.3 (vs. 6.4 prior), owing to relative improvement in FX reserves.
- **3Q prelim GDP will be released on 26 Oct. South Korea's economy grew +0.6% q/q in 2Q (final), slowing from +1.1% growth in 1Q due to base effects and decline in exports** (account for 40% of GDP). Gross fixed capital formation decelerated, led by construction while consumption firmed. **Breakdown by industry shows construction decelerated sharply.** On y/y basis, 2Q GDP was 2.7% (vs. 2.9% in 1Q).
- **Growth and Inflation Outlook:** BoK expects domestic economy to continue to improve and record a growth rate of 2.8% in 2017, as exports and facilities investment show robustness amid global economic recovery while slump in private consumption gradually eases. BoK also expects the economy to pick up in 2018, with growth projected to come in at 2.9% due to expansion in increasing trend of private consumption. We think fiscal stimulus (KRW11tn supplementary budget) as highlighted by President Moon (and

approved by parliament in end-Jul) should help to support private consumption and economic growth. Korea-US (KORUS) FTA may come under renewed focus as Trump has criticized the KORUS for its large trade deficit with S.Korea and have asked for renegotiation or risk termination again. While S.Korea authorities have rejected the proposal from US with no date being set for future meeting, the USTR said discussions will continue in coming weeks. The KORUS could potentially be terminated if either country said it wants to do so and the process will take 180 days. We do not expect the US-Korea relations to break down but do caution that unexpected deterioration could subject USDKRW to more upside pressure.

- **Headline inflation eased from 5-year high of 2.6% y/y in Aug to 2.1% y/y in Sep.** Food and non-alcoholic beverages as well as utility cost remain the main drivers of headline inflation. Core inflation slipped to 1.6% y/y in Sep (vs. 1.8% in Aug) and is expected to stay in the mid-to-upper range of 1%.
- **The big jump in Aug was due to seasonal factors such as heavy rain, summer heatwave and the recent incident related to contaminated eggs in South Korea were blamed for the sharp spike in fresh food prices.** Prices of eggs jumped 53.3% y/y in Aug after eggs from some local farms were found to be contaminated with potentially harmful pesticide while prices of radish and tomatoes surged 71.4% and 45.3%, respectively. The jump in inflation above BoK's 2% target is not expected to force the BoK to raise rate as **higher inflation was not from increase in domestic demand but seasonal factors.** Headline Inflation is likely to maintain its uptrend and stay elevated as South Koreans celebrate the National Chuseok holiday (3 - 6 Oct).
- **Monetary Policy Forecast: We still do not see a strong case for BoK to rush into raising rates at the next meeting (19 Oct)** despite the rise in Korea's inflation above BoK's target level of 2% level. This is unlikely to force the hand of BoK to tighten prematurely as inflation has been supply-side and seasonality driven. Inflationary pressures from the demand side remain soft for now. We expect BoK to keep monetary policy accommodative, with policy rate on hold at record low of 1.25% for the rest of the year (1 more meeting on 30th Nov 2017) to keep growth supported. There could be risk of tightening in 1H 2018 should growth momentum picks up further owing to supplementary budget and generate demand-pull inflation.
- BoK Board member Shin In-seok said that current monetary policy is accommodative. He elaborated that the real neutral interest rate for S.Korea has declined and the BoK's benchmark rate remains below the neutral rate. There are various reasons why real neutral interest rate has declined: (1) financial crisis, global economic participants deleveraged and reduced consumption, investments. More saving and less spending lowers the rate seen on equilibrium; (2) 5-year decline in consumption propensity in Korea due to ageing especially among the elderly who own homes and are indebted.
- **Latest Fiscal and External Balance Outlook:** Current account surplus widened to 5-month high of US\$7.02bn in Jul (vs. US\$5.08bn in Jun) owing to improvement in export of goods. This marked the 65th consecutive months of surplus but on y/y, current account surplus was

down 13%. Services balance saw a deficit of \$3bn, with travel account still seeing deficit due to rising outbound trips and decreasing inbound visitors. Number of Chinese tourists going to Korea fell 70% y/y in Jul.

- Korea’s sovereign debt is expected to increase to KRW682.4tn by end-2017, from KRW641tn. Government debt now stands at 44.8% of GDP. The rising debt has to do with tax cuts and increasing welfare spending made during former President Lee’s era. The National Assembly Budget Office estimates government debt will rise to KRW800tn in 3 years’ time.
- **Key domestic events and issues to watch:** S. Korea releases Sep exports (1 Oct); Sep PMI Mfg (2 Oct); Sep export & import prices (17 Oct); Sep unemployment rate (18 Oct); BoK meeting (19 Oct); Sep PPI (20 Oct); 20-days exports (23 Oct); 3Q prelim GDP (26 Oct); Sep IP (31 Oct).
- **Technical Outlook:** Our call in FX Monthly (sent 31 Aug) for USDKRW rebound to re-visit 1134 (50, 100 DMAs, 50% fibo retracement of Jul high to low) and 1140 (61.8% fibo), 1145 (200 DMA) were all met in Sep. Pair was last seen at 1146 levels. Bullish momentum on weekly and daily chart remains intact. Sustained price action above 1146 could see the pair trade higher towards 1158, 1165 levels. Support at 1136, 1130 levels. Bias to buy to buy on dips.



SGD: Climbing Steadily Higher

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDSGD	1.3500 (--)	1.3550 (1.3600)	1.3650 (--)	1.3700 (--)

Previous forecasts in parenthesis

- **Motivation for the FX View:** Sep saw the USDSGD dip to a new 2017 low of 1.3346 on 8 Sep on safe-haven plays arising from geopolitical tensions over North Korea. Since then though the pair has crept higher amid fading geopolitical tensions and on prospects of further rate hikes in the US (once more in Dec and at least 2 hikes in 2018) and prospects of US tax reforms. These have reignited USD bulls, lifting UST yields and USD higher. This in turn has weighed on the SGD and pushed the USDSGD higher to a high not seen since 18 Aug of 1.3647. Pair though has since eased off to hover around the 1.3570 levels at the point of writing. The swings in the SGD in Sep have resulted in the USDSGD being little changed. In Sep, the SGD dipped by just 0.13% against the USD. Nevertheless, this did not prevent the SGD from being the second best performing currency in ASEAN after the THB, gaining 6.6% against the USD.
- The strength in the SGD to date can be attributable to the lack of Trump reflation trades and the healthy macroeconomic fundamentals of the economy led by the synchronized recovery in exports in the

region. These have played a part in dampening aggressive upside in the USDSGD. In addition, the government's mildly expansionary fiscal policy, which together with still accommodative monetary policy, its triple-A status and persistent balance of payments surpluses, have also been supportive of the SGD and have capped overly aggressive climb in the USDSGD.

- To date, the ongoing synchronized recovery in exports in the region, and the historically low volatility environment as reflected in the equity and FX volatility indices have spurred greater flows into emerging market assets, including those in Singapore. This should be supportive of the SGD. Risk to this is that episodes of global risk-off could re-emerge, spurring a sell-off in regional equity assets, including Singapore, and weigh on the SGD, posing upside risk to the USDSGD.
- The SGD is expected to find support in 4Q from the MAS. We expect MAS to shift from its current 'neutral' policy stance to a 'mild appreciation bias' at its Oct meeting (expected sometime in 10-13 Oct). Strong economic growth momentum and the expected acceleration in core inflation should underpin this decision. Policy tightening by the MAS should be supportive of the SGD and mitigate some of the upside risks (see discussion below). The continuation of its neutral policy bias at its Oct meeting could see the USDSGD climb higher beyond the 1.36-levels by year-end.
- As we had previously cautioned in our previous Monthlies, our underlying assumption remains for the USDSGD to be supported in the next three-six months, underpinned by rising UST yields. UST yields should continue to climb higher given steady US economic growth, the Fed normalization of its USD4.5tn balance sheet beginning in Oct and expectations of even more rate hikes in 2018 (we expect at least 2 rate hikes in 2018). Thus, should US data continue to surprise on the upside, further uptick in UST yields are likely, keeping the USD and hence the USDSGD supported.
- We also are penciling in for the global reflation trade to kick in possibly in 2H 2018. The lift to the USD could come in even before this, possibly as early as in 2Q as UST yields rise in anticipation. The rise in UST yields is likely to have a significant impact on the USDSGD, given that the USDSGD is one of the most sensitive currency pair to moves in 10Y UST yields. This rise in UST yields is likely to narrow the yield differentials between the UST and SGS (assuming no change in SGS yields) and result in outflow of funds back to the US, lifting USD and be supportive of the USDSGD.
- We maintain our forecast for the USDSGD to end 2017 at 1.3500 with MAS tightening move in Oct supportive of the SGD and mitigate the possible USD strength from higher UST yields. We have tweaked our 1Q 2018 forecast to 1.3550 (from 1.3600 previously) for a more moderate rise in the USD following the Fed move in Dec 2017. Thereafter, we expect markets to begin re-pricing US reflation trades in 2H 2018 and should provide the USD with a lift and push the USDSGD higher to 1.3650 and 1.3700 by end-2Q and -3Q 2018 respectively.

- Singapore's monthly Maybank Vulnerability score (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) was unchanged 4.3. This should be supportive of the intrinsic value of the SGD. Our model shows that the SGD NEER was last seen 0.77% above the mid-point implied at 1.3711. Upper bound is implied at 1.3439 while lower bound is now at 1.3983.

Growth and Inflation Outlook: The economy, which has been driven by the synchronized recovery in exports in the region for the past few quarters, has spilled over to the services sector. This improvement in the services sector (which had expanded by 2.4% in 2Q vs. 1Q's 1.4%) could be attributed to gains in finance and insurance (2Q: 3.8% vs. 1Q: 0.7%), business services (2Q: 1.8% vs. 1Q: 0.9%) and wholesale & retail trade (2Q: 1.5% vs. 1Q: 0.1%). The recovery in services has also broadened to include the domestic services sector, such as "other services" (includes education, health, social services and the arts, entertainment & recreation segments), retail trade and property sector. Manufacturing growth shows no signs of slowing down with PMI for manufacturing and electronics still expanding, rising to 51.8 and 53.2 respectively in Aug from 51.0 and 52.2 in Jul. Nevertheless, we caution that base effects could weigh on manufacturing growth in 2H, leading to a moderation. For the full-year, we expect the pick-up in services to offset the moderation in manufacturing in 2H and lift the economy to 3.0% in 2017. MTI is just as optimistic, highlighting that the potential downside risk to growth "has eased". Not surprisingly, the MTI had narrowed its growth forecast range to 2-3% for 2017 from 1-3% previously. As for 2018, growth should continue to grow at a healthy 2.7% in 1H 2018 with full-year growth coming in at 2.4%.

- Headline inflation has yet to gain traction and has been broadly hovering below the 1.0% levels for most of this year. Recent data showed that headline inflation had softened in Aug, rising by just 0.4% - moderating from Jul's 0.6%. Weighing on headline inflation in Aug was private transport inflation, which fell to 2.6% y/y (vs. +3.5% in Jul). Core inflation - headline inflation less accommodation and private transport - also moderated in Aug to 1.4% as food and retail prices softened. Year-to-date, headline inflation has risen by 0.6% y/y, partly affected by base effects stemming from subsidies. Core inflation though is up by 1.5% y/y so far this year and may exceed our forecast, supported by the cyclical recovery. Stronger domestic growth, together with global oil prices averaging higher going into 2018, should be supportive of consumer prices. Risk to our inflation outlook though is subdued wage growth due to slack in the labour market and subdued economic environment could limit the extent to which businesses pass on higher costs to consumers. We continue to expect headline and core inflation to average 0.9% and 1.6% in 2017. We expect consumer prices to tick higher in 2018 with headline and core inflation averaging 1.2% and 1.7% respectively. MAS is forecasting headline inflation to average 0.5-1.5%, while projecting core inflation to rise 1-2%.

Monetary Policy Forecast: The MAS has maintained its 'neutral policy' stance since Apr 2016 with the slope of the SGD NEER policy

kept at zero percent. There was also no changes to the width of the policy band or the level at which the policy band is centered. We think that the neutral policy stance for “an extended period” has outlived its usefulness. The economy is expanding healthily amid a cyclical recovery and is poised to come in at the upper bound of the government’s 2-3% growth forecast range, while core inflation creeping higher due to the uptick in administrative prices (water, service and conservancy charges), higher global oil prices (on average) and a cyclical growth recovery. Our house view remains for a possible adjustment in the MAS policy stance at the Oct meeting with a likely shift to a ‘slight appreciation bias’.

The USDSGD rebounded from its new 2017 low not seen since Jun 2016 at 1.3346 (8 Sep) to hover within 1.3400-1.3550 range in recent days. The oscillation in the USDSGD has seen the 3-month SOR (3MSOR) touch a 2017 high of 1.023% on 25 Aug before coming off to hover around the 0.912% levels at the point of writing. The 3-month SIBOR (3MSIBOR) has been creeping higher and was last seen around the 1.123% levels. The still modest rise in rates suggests that the rise in mortgage rates remains on the slow grind higher. Deposit rates (for 12-month fixed) have also not risen since end-Jan but has remained at 0.33%. This continues to suggest that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, seems limited for now, though the risk could be rising.

- Upward pressure on domestic rates remain with Fed balance sheet reduction to begin in Oct and a further Fed rate hike penciled in for Dec. US 3MLIBOR continues on its upward trajectory and is currently hovering around 1.33%-levels at the point of writing, a new 2017 high. Ample liquidity has so far kept domestic rates from tracking the US 3MLIBOR higher though, allowing domestic rates to continue with its rather slow grind higher. For now, we expect the 3MSIBOR and 3MSOR edge higher to 1.46% and 1.24% respectively by end-2017. For next year, we expect the rates to accelerate to end 2018 at 1.87% and 1.65% respectively.

Latest Fiscal and External Balance Outlook: The government’s operating revenue rose to SGD18.96bn in 2Q17 from SGD16.60bn in 1Q17, while its operating and development expending slipped to SGD10.86bn and SGD4.36bn in 3Q to SGD17.74bn and SGD5.25bn in 2Q. This resulted in a budget surplus of SGD3.73bn in 3Q after a deficit of SGD6.39bn in 2Q. With the economy poised to expand at the upper bound of the government’s 2-3% growth forecast range this year, there could be further upside to tax collection this year. This should provide more fiscal room for the government to spend and support the economy in 2018.

- The current account (CA) surplus widened to SGD21.05bn in 2Q 2017 from SGD19.40bn in 1Q 2017. The increase in the CA surplus was due to larger surplus in the goods and services account (2Q: SGD26.96bn vs. 1Q: SGD25.19bn) that more than offset the deficits in the primary income (2Q: -SGD2.06bn vs. 1Q: -SGD1.50bn) and secondary income (2Q: -SGD3.85bn vs. 1Q: -SGD3.60bn) balances. The financial and

capital deficit rebounded sharply to SGD16.74bn in 2Q from SGD3.28bn in 1Q, underpinned by portfolio and ‘other’ investment outflows of SGD17.77bn and SGD18.88bn respectively vs. inflows of SGD0.50bn and outflow of SGD33.69bn in 1Q that more than mitigated the inflow of SGD12.56bn and SGD7.35bn in direct investment and financial derivatives respectively. Consequently, the overall balance of payments (BoP) surplus narrowed sharply to SGD4.44bn in 2Q from 1Q’s SGD16.61bn.

- **Key domestic events and issues to watch:** Advanced estimates for 3Q17 will be released sometime 9-13 Oct. At the same time, MAS will be announcing its bi-annual exchange rate policy decision on the same day.
- **Technical Outlook:** USDSGD rebounded for the month of Sep, in line with our call for rebound towards 1.3610, 1.3640. Pair traded a high of 1.3647 (28 Sep). Last seen at 1.3620 levels. Bullish momentum on daily chart remains intact while weekly momentum and stochastics continue to suggest rebound risks. Immediate resistance at 1.3630 (23.6% fibo retracement of 2017 high to low) before 1.3690 (100 DMA) and 1.3805 (38.2% fibo). Support at 1.3560 (50 DMA), 1.3510 (21 DMA) and 1.3410. Bias to buy on dips.



MYR: Still Remaining Resilient in a Tight Range

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDMYR	4.2500 (4.2750)	4.2750 (4.3000)	4.2000 (4.2500)	4.1500 (4.2500)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** We remain positive on the Ringgit outlook given support for fundamentals remain intact as data released over the first two months of 2Q such as industrial production, retail trade and trade data remain positive. Besides, BNM initiatives to broaden and deepen the onshore financial markets remain intact and help to shore up confidence. We interpret these steps as positive development and expect foreign investors’ confidence to gradually return. Thus far foreign investors interest in Malaysian equities and bonds, which have picked up the past few months has continued into Sep.
- Foreign investors return as net buyers of Malaysian equities so far this month (1-20 Sept 2017) at +MYR0.4b, reversing the -MYR0.2b net sell in Aug 2017. This coincided with the +1.7% month-to-date gain in MYR vs USD as it closed at 4.1980 on 21 Sep 2017 from 4.271 at end-Aug 2017.
- Furthermore, our Fixed Income Research Team indicated there is also foreign buying of Malaysian bonds this month, suggesting reversal from the -MYR0.7b net selling in Aug 2017, despite the maturity of

MYR12.6b Malaysian Government Securities (MGS) on 15 Sep 2017. This tally with our view that the risk of maturity-driven foreign selling in the domestic bond market has dissipated. This observation should ease concern about the upcoming MGS maturity on 31 Oct 2017 (MYR12.2b) and the Shariah-compliant Government Investment Issue (GII) maturity on 23 Nov 2017 (MYR7.5b).

- Trade flows still supportive of the MYR thus far. Export and import growth in July 2017 surged to +30.9% YoY and +21.8% YoY respectively from the slower growth of +9.9% YoY and +3.7% YoY in June 2017, reflecting calendar effect as the fasting month Ramadhan and Eid celebration fell between 27 May and 26 June this year vs between 6 June and 7 July last year. Trade surplus jumped +282.4% YoY to +MYR8.0b (June 2017: +MYR9.9b). YTD export and import growth were +22.3% and +23.0% respectively, and trade surplus in Jan-July 2017 totaled +MYR51.0b. Our full-year 2017 export growth, import growth and trade surplus forecasts remained at +15.3%, +16.8% and +MYR90.2b respectively. Next year, we are looking at +7.0% export growth, +7.8% import growth and +MYR90.0b trade surplus.
- Given improved investors' sentiment, well-managed expectation for Fed rate hike given pricing in of forward guidance this year, less dependence on oil for revenue, and MYR being fundamentally and historically undervalued, we see scope for Ringgit to play catch up with regional peers and extend its gains towards 4.25 levels (vs the USD) for 4Q, before some strength in the USD early next year potentially supporting the pair at around 4.2750 in 1Q 2018. Our forecasts already reflect our concern that there could be some risk of delayed tightening by the Fed and further delays in a US fiscal stimulus.
- We reiterate our **long-standing bias that the Ringgit remains fundamentally undervalued**. Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.70 levels. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We believe stability is gradually returning to Ringgit as political/ contingent liability risk subsides, fiscal consolidation gains traction, oil prices continue to stabilize and uncertainty subsides. Solid underlying fundamentals and policies, backed by domestic demand, re-calibrated supportive budget (on a lower oil price assumption suggests flexibility in the fiscal space), relative stability in oil prices though some downside pressure exists, relative attractive yields in the MGS, stabilizing FX reserves to retained imports & short-term debt, accommodative monetary conditions (to support businesses) remain intact and should provide an anchor for MYR stability once short-term noises subside. We believe USDMYR range of 4.20-4.40 is likely to remain relatively sustained for 2017.
- **Positive Development to Deepen Onshore Financial Markets.** According to BNM press release (13 Apr), the Financial Markets Committee (FMC) announced a number of initiatives targeted to promote (1) a fair and effective market, (2) improve bond market liquidity; (3) ease hedging activities and; (4) enhance transparency

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

- Total gross external reserves rose +USD0.3b to USD100.8b at mid-Sep 2017 (end-Aug 2017: USD100.5b) amid signs of portfolio capital inflows given MYR gain so far this month. Current reserves level is also adequate to deal with potential capital flow risk based on its ratio to IMF's Assessment of Reserve Adequacy (ARA) metric of 115%.
- **Growth and Inflation Outlook:** Our economics team maintains the 2017 full-year growth forecast to +5.5% from +5.1% previously, mainly on firmer domestic demand growth (2017E: +6.5% vs +6.3% previously; 2016: +4.3%) as net external demand is expected to be a drag rather than driver on growth, although less than previously projected (2017E: -4.6% vs -6.6% previously; 2016: +1.5%). The upward revision is mainly on account of faster growth forecasts for manufacturing (to +5.6% from +5.0%) and services (to +5.9% from +5.8%) on the supply side, and the higher growth of consumer spending (to +6.7% from +6.4%), private investment (to +9.4% from +8.7%) as well as exports (to +8.5% from +7.8%) and imports (to +10.3% from +9.7%) of goods and services on the demand side. We expect the above-5% growth momentum to be sustained in 2018, albeit at a slightly slower pace of 5.1% (+4.9% previously).
- Index of leading economic indicators rose to +2.7% YoY in July 2017 (June 2017: +0.6% YoY), suggesting the real GDP growth momentum is intact in 3Q 2017 after the +5.7% expansion in 1H 2017. Our full-year 2017 real GDP growth forecast of +5.5% priced in moderation in 2H 2017. This is partly due to base effect as growth slowdown since 2H 2014 bottomed in 1H 2016, and picked up in 2H 2016, which was sustained in 1H 2017. Consumer spending which makes up 54% of GDP will be key to watch. In fact, industrial production picked up to +6.1% YoY in July 2017 (June 2017: +4.0% YoY) as manufacturing output clocked its fastest growth in three years of +8.0% YoY (June 2017: +4.7% YoY). Short-term outlook remains positive as global

manufacturing PMI picked up to 53.1 in Aug 2017 (Jul 2017: 52.7), the highest in over six years.

- Headline inflation rate in Aug 2017 rose to +3.7% YoY (Jul 2017: +3.2% YoY) while core inflation moderated to +2.4% YoY (Jul 2017: +2.6% YoY). For Jan-Aug 2017, headline inflation rate was +3.9% YoY (Jan-Aug 2016: +2.3% YoY) and core inflation rate was +2.5% YoY (Jan-Aug 2016: +2.7% YoY). Maintain our full-year 2017 inflation rate forecast at 3.5%-4.0% (2016: +2.1%) and view that there will be no change in OPR this year.
- After four consecutive months of deceleration, headline inflation rate picked up to +3.7% YoY in Aug 2017 (Jul 2017: +3.2% YoY; Maybank-KE: +3.3% YoY; Consensus: +3.4% YoY). The higher headline inflation was mainly contributed by “Food & Non-Alcoholic Beverages” and “Transport”. Meanwhile, core inflation rate which excludes volatile food and energy prices as well as price-controlled/price-subsidised components of the CPI, including fuel prices) remained contained (Aug 2017: +2.4% YoY; Jul 2017: +2.6% YoY). Compared with Jul 2017, headline inflation rose +0.9% MoM (Jul 2017: -0.1% MoM) while core inflation was up by +0.3% MoM (Jul 2017: +0.2% MoM).
- Our economists reiterate our view that the current trend in inflation is in line with our assessment that headline inflation has peaked in Mar 2017 and the outlook is for inflation to moderate going forward to average 3.0%-3.5% YoY in 2H 2017, especially as the base effect from lower crude oil price last year versus firmer price this year dissipated in 4Q 2016. Hence, we maintain our 2017 and 2018 headline inflation rate forecasts of 3.5%-4.0% (official 2017: 3.0%-4.0%; 2016: +2.1%) and 2.0%-2.5% respectively. For Jan-Aug 2017 period, headline inflation rate was +3.9% YoY (Jan-Aug 2016: +2.3% YoY) while core inflation rate was +2.5% YoY (Jan-Aug 2016: +2.7% YoY).
- This expectation reflects the view that the current “cost-push” headline inflation - largely due to the impact of the earlier surge in crude oil price on the domestic fuel prices which is a key element of the CPI’s “Transport” component - will taper, while “demand-pull” and “wage- driven” inflationary pressures are contained as suggested by the stable core inflation rate.
- Maintained our call that the Overnight Policy Rate (OPR) will be kept at 3.00% p.a. at the last meeting for the year on 8-9 Nov 2017. We continue to see little motivation for BNM to alter current monetary policy stance as the as the pickup in economic growth this year is to be accompanied by stable core inflation and MYR, sustained current account surplus, improved external reserves and expectation of gradual monetary policy normalization by US Fed.
- **Monetary Policy Forecast:** BNM kept the Overnight Policy Rate (OPR) at 3.00% after its MPC meeting on 6-7 Sep 2017. Monetary Policy Statement (MPS) continues to reflect BNM outlook of better-than-expected growth this year with moderating inflation. Maintained our view that OPR will stay at 3.00% at the final MPC meeting for the year on 8-9 Nov 2017, followed by a modest +25bps hike in 2018.

- Similar to the previous MPC meeting, the Monetary Policy Statement (MPS) indicated that BNM expect this year's real GDP growth to come in better than expected amid the synchronized and entrenched strengthening of global economic growth that lifted global trade, hence Malaysia's exports. This is on top of the favourable factors underpinning consumption and investment that support domestic demand, namely improving incomes and labour markets conditions, new and ongoing infrastructure projects, and sustained capital investment by firms in the manufacturing and services sectors. Current official 2017 real GDP growth forecast is a range of +4.3% to +4.8%, and we expect this to be revised upward to above +5.0% when Budget 2018 is tabled at the Parliament on 27 Oct 2017, together with the release of the Government projection for 2018. Our 2017 and 2018 real GDP growth forecasts are +5.5% and +5.1% respectively (1H 2017: +5.7%; 2016: +4.2%).
- At the same time, BNM maintained its view that headline inflation will moderate for the rest of 2017 (Jan-Jul 2017: +4.0% YoY; 2016: +2.1%), reflecting the waning effect of "cost-push" factors, while core inflation will be sustained by robust domestic demand but remain contained (Jan- Jul 2017: +2.5% YoY; 2016: +2.5%).
- No change in our view of OPR staying at 3.00% this year. Overall, we see BNM is comfortable to keep the current monetary policy stance unchanged this year amid positive growth momentum, receding inflationary pressures and the stabilisation and strengthening of MYR. Additional motivation to maintain OPR at current level is the uncertainties to the outlook coming mainly from political and policy developments in the major economies as well as geopolitical risk.
- **Latest Fiscal and External Balance Outlook:** Themed "Accelerating Growth, Ensuring Fiscal Prudence, Enhancing Wellbeing of People", Budget 2017 maintains commitment to fiscal discipline and consolidation; supports domestic demand via corporate income tax rate cut, incentives for tourism, SMEs, exports and digital economy, and infrastructure investment; and focuses on the wellbeing of the low-and middle-income groups by addressing the issues of inclusivity, equality, cost of living and affordable housing.
- Budget deficit target for 2017 is set at -3.0% of GDP, sustaining the policy of fiscal consolidation since 2010. This year's aim of -3.1% of GDP is maintained and achievable. Based on monthly data, we estimated budget deficit in Jan-Aug 2016 was -3.9% of GDP as the deficit of -5.6% of GDP in 1H 2016 turned into an estimated surplus of +1.2% of GDP in July-Aug 2016. We expect the fiscal deficit to remain flat at 3.1% of GDP, as government spending is likely to pick up (as we enter the election campaign).
- Current account surplus widened in 2Q 2017 to +MYR9.6b or +2.9% of GDP (1Q 2017: +MYR5.3b or +1.6% of GDP) on larger goods account surplus and smaller deficits both services and income accounts. We revised current account surplus forecast to +MYR31.1b or +2.3% of GDP from +MYR23.2b or +1.8% of GDP previously (2016: +MYR29.0b or +2.4% of GDP).

- Despite the persistent worries over the current account surplus tipping into deficit given the earlier narrowing trend, our economics team maintain their view of that current account surplus will be sustained, especially with the on-going global economic growth recovery (2017E: +3.5%; 2016: +3.2%) that uplifts world trade growth.
- **Key domestic events and issues to watch:** BNM policy decision (9 Nov); Trade data (6 Oct); FX reserves (6, 20 Oct); Industrial Production (12 Oct); CPI (20 Oct); Nikkei Malaysia PMI (2 Oct).
- **Technical Outlook:** USDMYR traded lower towards 4.18 last month but rebounded towards month-end. Last seen at 4.2340 levels. Daily momentum has turned mild bullish while stochastics is rising from oversold conditions (may pose short term rebound risks). Resistance at 4.25, 4.2740 (100 DMA). Support remains at 4.20, 4.1720 (50% fibo retracement of 2016 low to 2017 high).



IDR: Fading Carry Trades Weighs

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDIDR	13600 (13400)	13600 (13450)	13700 (13450)	13650 (--)

Previous forecasts in parenthesis

- **Motivation for the FX View:** The IDR has come under pressure in recent days amid a firmer USD. This has resulted in the IDR being one of the worst performing ASEAN currencies in Sep. The IDR has weakened by nearly 1% against the USD in Sep. The downside pressure on the IDR has resulted in the USDIDR breaking out of the upper bound of its recent trading range of 13300-13450 that has held for most of the month. It was not domestic factors that weighed on the IDR but external ones, namely the hawkish Fed with more hikes to come, and the optimism over the progress of tax reforms in the US. Consequently, this has lifted the USDIDR higher and a retest of the 13600 levels cannot be ruled out. We remain bearish IDR for the next three to nine months.
- Nothing fundamental has changed in Indonesia. Domestic fundamentals remain healthy with the current account deficit (CAD) on the path to improvement though in the near term we could see some deterioration, and the reform process still underway, which have helped to keep the IDR supported amid external headwinds. Though real GDP is currently hovering around the 5% levels so far, there could be upside risk to this growth outlook given the two rate cuts by BI so far this year. In addition, the 15 reform/stimulus packages introduced so far that should help to cut red tape and liberalize rules that have been a drag on the economy as well as the government infrastructure push should be supportive of growth

ahead. As for the CAD, BI expects CAD to average 1.91% of GDP in 2H, and this together with 1H CAD at 1.5%, full-year CAD should come in at 1.7% of GDP. This is an improvement over the deficit of 2.2% in 2Q last year. It is also important to note that the CAD can be attributed to capital goods import for infrastructure building, which should eventually lift potential growth higher.

- At the same time, the government is taking the necessary steps to rein in the budget deficit under the watchful eyes of Finance Minister Sri Mulyani. Unlike the previous year where the focus was on raising revenue, efforts this year are on cutting unnecessary expenditure. Reducing waste and using resources more efficiently should provide the government in 2017 to push forward its ambitious USD400bn infrastructure building programme. This should not only lift potential growth but the IDR as well.
- We caution that there could be some slowdown in inflows to Indonesian debt, though not necessary a complete reversal of flows. So far, the historically low volatility environment as reflected in the equity and FX volatility indices has spurred greater flows into emerging market assets, including those in Indonesia. Year-to-date to Sep, foreign investors have purchased USD11.53bn in Indonesian debt compared to the USD7.65bn purchased for the whole of 2016. The IDR has generated volatility-adjusted carry trade returns of 2.1% in Sep, though this was a slowdown from Aug's 2.6% and Jul's 2.97% and this has fueled inflows into Indonesian assets.
- Nevertheless, waning carry trades is likely to persist given the narrowing yield differentials between UST and Indonesian debt and this should weigh on Indonesia assets and the IDR in the quarters ahead. In addition, there are other risks to our IDR outlook, including falling commodity prices that could depress private consumption and potential disruption to global trade from restrictive trade policy in the US that could moderate the synchronized export recovery in the region. These too are likely to diminish the attractiveness of the IDR carry trade and could potentially spur a sell-off in Indonesian assets. Note though that interest in Indonesian debt could re-ignite given Indonesia's strong fundamentals currently as and when carry trade resume. This should be supportive of the IDR.
- We expect more moderate inflows into Indonesian debt consequently, especially after the recent policy rate cut by the BI. At the same time, UST yields have started to spike on the back of a confluence of factors, namely expectations of more Fed rate hike (we are expecting at least two more hikes in 2018) and optimism over the progress of tax reforms in the US. This jump in UST yields have increased the risk to emerging market, including Indonesia, that domestic rates will have to rise in tandem to prevent portfolio outflows.
- Our baseline USDIDR forecast had not initially priced-in these two rate cuts. The surprise BI cuts to the policy rate have not weighed significantly on the IDR. However, with the advent of UST yield rally, this has triggered some sell-off in Indonesian debt and lifted the USDIDR higher than anticipated. Given these market developments, we have revised our USDIDR forecast and not because of any deterioration in Indonesian fundamentals. We now expect the

USDIDR to hover around 13650 levels by the end of 2017 and in 1Q 2018 before inching higher to 13700 by end-2Q 2018, lifted by expectations of the re-emergence of reflation trades in the US that should kick off in 2Q. Thereafter, we expect some USD fatigue to set in, allowing the pair to ease off to 13650 by end-3Q 2018.

- **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Indonesia was unchanged at 5.2. This should be supportive of the intrinsic value of the IDR.
- **Growth and Inflation Outlook:** The BI is expecting growth to improve in 3Q17, driven in part by improvement in household consumption and improvement in government spending. This is reflected in the healthy month-on-month growth in car and motorcycle sales in Aug, which were up by 13.1% and 3.1% respectively. This though was a moderation from Jul's 28.5% and 41.8%. External demand remains healthy as the synchronized recovery in exports in the region continues. Exports continue to expand at a double-digit pace of 19.25% y/y in Aug, though this was a slowdown from Jul's 41.06%. Imports though rose slowed even more, rising by just 8.89% y/y in Aug from 53.99% in Jul, signaling some signs of fatigue in consumption and investment spending. Nevertheless, the government's push ahead to implement President Jokowi's USD400bn infrastructure program should not only bolster growth in the near term but also potential growth. The recent moves by BI to ease monetary policy should be supportive of growth as well. Consequently, BI maintains 2017 growth projection at the 5.0-5.4% range and for growth to accelerate to 5.1-5.5% in 2018. Our economic team is not as sanguine even as they expect the government's fiscal push to drive growth for the rest of the year and into 2018, penciling full-year growth to come in at 5.07% for 2017. For 2018, our team expects growth to rise to 5.30%.
- Headline inflation remained below the 4.0% levels for the second straight month in Aug. Headline inflation rose by 3.82% y/y in Aug, moderating from Jul's 3.88%. The more moderate rise in inflation was due to stable food prices (holding up around 1.5% y/y in Jul and Aug) and slippages housing, clothing and health costs (Aug: 5.66%, 2.28% and 3.43% y/y respectively vs. Jul: 5.99%, 2.36% and 3.62%) that offset the rise in transport costs (Aug: 4.89% vs. Jul: 4.44%). Core inflation dipped to the 2% levels for the first time since inflation data was rebased. Core inflation rose by 2.98% y/y in Aug compared to 3.05% in Jul. Our economic team expects inflationary pressures to be tamed for the rest of 2017. Food prices should remain benign, helped not only by the government's readiness to import food supplies but by good weather as well. Just as important, the government is halting moves to increase petrol, fuel, gas and power tariffs until the end of the year that should help to restrain price pressures. Consequently, the team now projects headline and core inflation to average 3.95% and 3.18% in 2017 respectively, which is in line with BI's projection for headline inflation of 3.0-5.0% for 2017. For 2018, the team is looking for a slightly easing in consumer prices with headline inflation averaging 3.79% for the full-year.

- **Monetary Policy Forecast:** BI cut its benchmark 7-day reverse repo rate by 25bp to 4.25% at its 22 Sep policy meeting. This is the second 25bp cut to the policy rate this year, bringing the total reduction to 50bp. At the same time, the deposit and lending facility rates were also both cut by 25bp to 3.50% and 5.00% respectively. This meant that the interest rate corridor was maintained at 75bp on either side of the policy rate. The BI move was a surprise as consensus, including our economic team, had been expecting the status quo to be maintained. The BI had taken advantage of muted inflation and stable IDR to reduce rates again. YTD inflation was 3.94%, well-within the BI's comfort zone of 3-5%. Inflation is expected to remain manageable going into 2018, coming in at a tighter 2.5-4.5% range in 2018. The IDR has been relatively stable, hovering around the 13100-13500 since Jul. YTD, the IDR has gained 1.44% against the USD. This provided room for the BI to boost credit growth and hence economic growth through lower rates.
- With three more policy meetings left for the rest of the year, we think that further moves by BI will be data-dependent, particularly inflation and growth data. Should credit growth remain lackluster and fail to pick up towards its 10-year (2007-2016) average of 19%, the risk of further rate adjustments by BI rises. Still, we think that the central bank will be patient and allow the two previous rate cuts to work their way into the economy as well as to gauge their effectiveness on credit growth. In addition, we think that BI may have to tread with care as external risk may intensify especially with G7 central banks on a tightening bias. This suggests that the room for further rate cut could be limited for the rest of the year. Our economic team does not expect any further rate cut this year.
- Aside from rate cuts, we cannot discount the possibility that BI turn its focus on macro-prudential policies as well to lower lending cost and boosting growth. Already BI has announced that it would allow commercial banks to include holdings of corporate bonds as part of loan-to-funding ratio as well as relaxation of financing-to-funding ratio, allowing more lending room to banks. Further macro-prudential measures will be rolled out by the central bank "soon".
- **Latest Fiscal and External Balance Outlook:** The finance commission of Parliament has approved the macroeconomic assumptions for the 2018 state budget. The GDP and inflation assumptions were set at 5.4% and 3.5% as proposed by the government. The exchange rate assumption though was revised to 134000 to the USD from 13500. As well, the average rate on 3-month bills was revised to 5.2% from 5.3%.
- The current account deficit (CAD) widened to USD4.96bn in 2Q, almost double the USD2.36bn deficit in 1Q 2017. This deficit is equivalent to 1.96% of GDP in 2Q compared to 0.98% in 1Q. The wider current account deficit was due to a drop in the goods and services account surplus to USD2.48bn from USD4.39bn in 1Q and wider deficit in the primary account (-USD8.54bn in 2Q compared to -USD7.77bn in 1Q). The financial account surplus narrowed to USD5.86bn in 2Q from 1Q's USD7.97bn due to the wider outflow from the other investment account of USD6.16bn (1Q: -USD1.28bn). Consequently, the overall balance of payments surplus narrowed sharply to USD0.74bn in 2Q

from USD4.51bn in 1Q. The BI expects the BoP to remain in a surplus in 2017 but to moderate to USD8-9bn from USD12bn in 2016. Given the larger deficit in 1H17 of USD3.57bn, our economic team now expects the CAD widen even more to 1.38% of GDP from 1.15% previously. The team continues to expect greater import of capital goods to support the government’s infrastructure program to underpin the CAD in 2017. In comparison, the BI is penciling a CAD of 1.7% for 2017 and around 2% for 2018.

- **Key domestic events and issues to watch:** BI meeting on 18-19 Oct will be closely watched for further rate adjustments.
- **Technical Outlook:** USDIDR was last seen at 13560 levels. Bullish momentum indicators on weekly and daily chart are bullish bias. Next resistance at 13600, 13700 levels. Support at 13330 (21, 50, 100, 200 DMAs).



PHP: Near Term Weakness To Persist

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDPHP	52.00 (--)	52.00 (--)	51.80 (--)	51.50 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** The PHP has gone from being a laggard among ASEAN FX to one of the best performing currency in Sep. The PHP has gained 0.65% against the USD in Sep after slipping 1.38% in Jul, performing even better than the SGD, THB and IDR. Driving the PHP higher continues to be a confluence of factors, namely its strong growth momentum, accommodative monetary policy and progress on its tax reform package. Together these factors have been supportive of the PHP and allowed the USDPHP to end Sep below the 51-handle. These gains by the PHP though were mitigated partially by the rally in UST yields and the USD towards the end of Sep. In addition, comments by the Finance Secretary for a weaker PHP are also weighing on sentiments. These have kept the USDPHP hovering just below the 51-handle as at the end of Sep. Nevertheless, further uptick in UST yields and USD should weigh on the PHP and keep the USDPHP supported above the 51-handle in the near term. We remain bearish on the PHP in the next three-to-six months.
- In the next three-to-six months, global rates are poised to climb higher as the advanced economies tighten policy, particularly in the US where the Fed remains on the tightening bias (one more hike in Dec and at least two more in 2018) and is unwinding its balance sheet. At the same time, US tax reforms and the re-emergence of US reflation trades should kick-in in 2Q 2018, keeping UST yields supported. We expect UST yields to remain elevated consequently and

the narrowing yield differentials between the UST and Philippines sovereign bond could exacerbate portfolio outflows. At the same time, others in G7, namely Canada, UK and EU, are either tightening or in the process of tightening policy and the higher returns elsewhere could encourage even greater outflows from Philippine assets. With the USDPHP among the most sensitive to UST yields, rallies in UST yields should lift the USDPHP higher and possibly towards the 52-handle by end-2017 and into 1Q 2018.

- Also underpinning PHP weakness is the political risk emanating from the ongoing conflict in Marawi City on Mindanao Island. The inability of the authorities to bring the situation under control and the extension of martial law on Mindanao Island till end-2017 has weighed on investor sentiments. Also not helping is the deteriorating current account with latest data showing a shortfall of USD0.23bn or 0.2% of GDP in 1H 2017. The BSP expects the current account to slip into its first deficit in 15 years of USD0.60bn in 2017. These investor concerns are likely to encourage greater short net-PHP bets, which are supportive of the USDPHP.
- Support for the PHP from monetary tightening is unlikely in 2017. With growth still expanding at a healthy above-6% pace, and inflation manageable and well-within the central bank's comfort zone of 2-4%, moves by the BSP to adjust its key policy rate is unlikely. Our economic team notes that manageable inflation outlook should allow the central bank to maintain its current accommodative policy to support domestic growth momentum. The absence of monetary action by the BSP this year should keep the USDPHP supported above the 51-handle in 2017. Going into 2018 though, the central bank should be on a tightening bias as inflation is expected to accelerate as the economy continues to outperform and as the tax reform bill comes into effect. Our team is looking for two 25bp rate hikes in 2018, possibly in 2Q and 3Q, which should be supportive of the PHP.
- We also expect some of the USD strength to be mitigated by the implementation of tax reforms in the Philippines. We expect the tax reform bill to become law before the end of the year and implemented by 1 Jan 2018. There are currently two versions of the tax reform bill - one by the House and the other by the Senate. Both versions offer cuts to personal income tax but the threshold for exemption from income tax differs, and raise excise tax on fuel, new cars and sugary drinks though the amount of tax differs as well. The House tax bill is expected to generate PHP82bn in annual revenues, half of the projected PHP162bn originally proposed by the Department of Finance, while the Senate's version would raise at least PHP130bn. The final reconciled bill by both the House and Senate should help to partially fund the government's ambitious PHP8tn infrastructure programme that includes new roads, railways, bridges and airports. The tax bill, when implemented, should lift investor confidence and spur both portfolio and FDI inflows, keeping the PHP supported. We look for the USDPHP to come off and end-2Q and -3Q 2018 at 51.80 and 51.50 respectively.
- In addition, support for the PHP could come from the continuing inflows into the Philippines equity market. This is because of

favourable valuations in the stock market after the sell-off in the equity market between Aug 2016 and Mar 2017. According to our estimates using the Cyclical Adjusted P/E (CAPE) ratio, equities are now relatively cheaper (as reflected by estimated P/E ratios minus their 5-year average P/E ratios) compared to its peers and this could attract even greater foreign inflows. We are already seeing greater inflows into Philippine equities with foreign investors having purchased USD569.87mn in Sep compared to just USD49.59mn and USD38.41mn in Aug and Jul respectively. In contrast, they had purchased USD38.4mn in Jul. Still, further inflows should go some ways to mitigating some of the downside risks to the PHP and be supportive of the PHP.

- We maintain our USDPHP forecast for the next two quarters that reflects near-term risks to the PHP. We expect the USDPHP to climb towards the 52-handle in 4Q 2017 and to hover around that level by end-1Q 2018. Thereafter the USDPHP is expected to ease off to around 51.80 and 51.50 by end-2Q and -3Q 2018 on improving domestic fundamentals.
- Our monthly **Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, improved to 4.8 from 4.9. This should be supportive of the intrinsic value of the PHP.
- **Growth and Inflation Outlook:** The healthy growth should extend into 3Q and beyond supported by consumer and government spending. 2H 2017 pace of growth should be similar 1H. Our economic team expects consumer spending to remain resilient in 2H 2017, supported by favorable demographics and job market conditions, sustained by overseas remittances. Overseas remittances average 5.0% in the Jan-Jul period, an improvement over the 2.8% decline for the whole of 2016. They also expect some acceleration in spending towards the end of the year ahead of the possible tax hike should the proposed tax reform is passed before year-end. Should there be any delay in the passage and implementation of new infrastructure projects, our team expects growth to come in at the lower end of the government's 6.5-7.5% growth forecast for 2017. Support for growth is likely to come from the synchronized recovery in exports in the region. So far this year, exports have increased by 16.3% y/y, while imports are up 12.3%. Our economic team maintains their 2017 growth projection at 6.4%.
- Headline inflation accelerated by 3.1% y/y in Aug, up from 2.8% in Jul. Driving inflation in Aug was higher food prices and increases in transport and housing cost. Food prices rose 3.1% y/y in Aug (Jul: 2.8%), while housing and transport cost were up by 2.8% and 4.4% y/y respectively (Jul: 2.2% and 3.8%). Core inflation (headline inflation less selected food items and energy prices) also accelerated by 3.0% y/y in Aug from 2.8% in Jul. For the first eight months of 2017, headline and core inflation averaged 3.1% y/y and 2.8% respectively. Our economic team expects base effects from relatively higher inflation rate towards end 2016 to limit upside to inflation in 2017. As such, the team maintains its 2017 and 2018 headline inflation forecast at 3.0% and 3.5% respectively. BSP's full-year headline inflation

forecast remains at 3.1% for 2017 and well-within its inflation target range of 2-4%. Nevertheless, our team sees risks still to the upside on transitory impact of the proposed tax reform program and adjustments in transportation fares, though improvement in productivity should likely temper the impact on inflation over the medium term.

- **Monetary Policy Forecast:** For the sixth consecutive meeting this year, the BSP left its key policy rate - the overnight reverse repurchase rate - at 3.0%. The overnight lending rate and overnight deposit rate were also left unchanged at 3.5% and 2.5% respectively, leaving the interest rate corridor symmetrical on either side of the policy rate by 50bp. The prevailing policy rates have been in place since Jun 2016 when the interest rate corridor framework was adopted. The reserve requirement ratio (RRR) was also kept steady at 20%.
- With only two more policy meetings left in 2017, the BSP remained data-driven and “will continue to be vigilant against any risks to the inflation outlook and will adjust its policy setting as needed to. For now, the BSP remains comfortable with inflation, maintaining its 2017 and 2018 inflation forecast at 3.2%. It did revise upward however its 2019 inflation forecast to 3.2% from 3.1%. The forecasts still showed inflation well-within the 2-4% inflation comfort zone. Our economic team now holds a similar view as the BSP. Our team believes that the manageable inflation outlook should allow the BSP to keep its benchmark interest rate on hold for the rest of the year. The team though however expects the BSP begin its tightening cycle in 2018 with two 25bp rate hikes penciled-in in 2018.
- **Latest Fiscal and External Balance Outlook:** The House of Representatives has given its nod to the government’s PHP3.77tn budget for 2018. The bill now heads to the Senate for its approval. The government budget swung back to a surplus in Aug, recording a PHP28.81bn surplus compared to the deficit of PHP50.51bn in Jul. This followed from revenue jumping to PHP230.41bn in Aug (Jul: PHP194.62bn) and expenditure dipping to PHP201.60bn (Jul: PHP245.13bn). For the first eight months of the year, the deficit was at PHP176.17bn with government revenue coming in at PHP230.40bn and expenditure at PHP201.6bn. The government continues to target the deficit at 3% of GDP until 2022.
- The balance of payments (BoP) remained in deficit for the fourth consecutive month. The deficit narrowed to USD7.3mn in Aug from USD678.1mn in Jul with detailed breakdown of the components of the BoP unavailable at the point of writing. The deficit for the Jan-Aug period was USD1.39bn, wider than the USD0.42bn deficit for the whole of 2016. As for the current account, latest data showed the current account registered a shortfall of USD0.23bn or 0.2% of GDP in 1H 2017. The BSP expects the current account to record its first deficit in 15 years of USD600mn in 2017. Meanwhile, the BoP deficit is expected to widen to USD500mn (-0.2% of GDP) in 2017 from -USD400mn (-0.1% of GDP) in 2016.
- **Key domestic events and issues to watch:** Inflation data due on 5 Oct and overseas remittances on 16 Oct will be eyed for the health of

the economy. The Senate will debate its tax reform bill and is expected to pass the bill by mid-Oct.

- **Technical Outlook:** USDPHP was last seen at 51.10 levels. Bullish trend channel formed since mid-2013 remains intact. Resistance seen at 51.80. Support seen at 50.50 (100 DMA) before 50.20 (200 DMA).



THB: Drag Lower By Narrowing Real Yield Differentials

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDTHB	34.00 (--)	34.00 (--)	34.30 (--)	34.80 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** The THB remains the best performing currency in ASEAN against the USD so far in 2017 but its shine could be fading. The THB had gained 7.57% against the USD so far this year. But in the month of Sep, the THB proved to be among the worst performing currency, slipping 0.39% against the USD. This reversal in the THB can be attributed to the rally in UST yields and the USD towards the end of Sep on the back of expectations of further Fed rate hike into 2018 and optimism over progress of US tax reforms. At the same time, the USDTHB was pressured lower by falling gold prices (as geopolitical risks fade) given that gold prices and the USDTHB are negative correlated. Not surprisingly, the USDTHB has broken out of its 33.000-33.260 range that has held since the start of Sep and bounced to a multi-week high of 33.495 (28 Sep). We remain bearish on the THB.
- As we had expected, real 10Y Thai bond yield has slipped lower to 1.43% in Sep from 2.0% in Aug, while US real bond yield is now around 0.4% vs. Aug's 0.2%. The narrowing real yield differentials between 10Y UST and the Thai government bond has lowered the real return from investing in Thai debt and is spurring outflows from Thai government debt in search of higher returns elsewhere. The lower real 10Y yield has made the THB less attractive as a carry trade. This was reflected in the carry trade returns adjusted for volatility for the THB declining by 2.04% - the worst among the ASEAN FX - from 2.84% in Aug. This suggests that THB is no longer favoured as a carry trade with Thai bonds losing its appeal to its peers, particularly the IDR. The fading attractiveness of the THB as carry should weigh on the THB.
- With the BoT holding steady on monetary policy and the US rates on the upmove, we can expect the 10Y US-Thai debt yield differentials to narrow. The yield differential can narrow even more should US deflation trades re-emerge in 2018. These moves could lift UST yields and support the USD even further. This in turn should keep the USDTHB supported going into 2018. Similarly, other major G7 central

banks are either tightening or on the verge of tightening monetary policy and higher returns elsewhere could spur further outflows from Thai assets and weigh on the THB.

- Recent flows data confirms this fading attractiveness of Thai bonds to foreign investors. In the last week of Sep, foreign investors sold off USD0.77bn in debt. This was after they had purchased USD3.61bn of debt in the first four weeks of the month. Similarly, foreign investors also sold off USD68.59mn of equities in the last week of Sep after purchasing USD142.54mn in the previous four weeks. Though the overall flows remains positive in Sep, the sell-off in the last week of the month could be the start of outflows from Thai assets. Further outflows should weigh on the THB and lift the USDTHB higher.
- On the political front, political risks could rise after the funeral ceremony for the late King HM Bhumibol on 26 Oct, and the coronation of HM King Maha Vajiralongkorn, which should follow soon after. This is because there should be more clarity on the election schedule towards the end of the year. Simmering tensions could resurface in the run-up to the general elections, expected sometime mid-2018. Political uncertainty ahead of the general elections could keep foreign investors on the sidelines until there is clarity on the political front. This could weigh on THB sentiments and support the USDTHB around the 34-handle by the end of the year. For now, the current political calm in the kingdom ahead of the royal cremation and coronation is providing the impetus for an economic growth recovery and investment inflows, keeping the THB supported around the 33-levels. Even the sentencing of former PM Yingluck in-absensia to five years imprisonment did not rock the political calm.
- Though we expect THB weakness ahead, we do not expect the currency to dip aggressively. This is because the currency remains supported by its current account surpluses. Thailand is only one of the few ASEAN economies enjoying not only current account surpluses and but double-digit surpluses as well. Recent data showed the current account surplus at 10.6% of GDP for 2Q 2017. This persistent current account surplus (since 1Q 2014) should continue to put the spotlight on the THB vis-à-vis its regional peers (with the exception of Singapore) and backstop the THB against any aggressive moves to push it lower. The persistent and strong current account surplus is positive for investor sentiments and hence the THB.
- We maintain our USDTHB forecast for the pair to end-2017 at 34.00. We expect more moderate USD strength by end-1Q 2018 to allow the USDTHB to hover around the 34-handle still before the pair climb higher to 34.30 and 34.80 by end-2Q and -3Q 2018.
- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) for Thailand as unchanged at 4.1. This should be supportive of the intrinsic value of the THB.
- **Growth and Inflation Outlook:** The outlook for the economy appears to have brightened. Growth momentum accelerated in the past three quarters with the latest quarter (2Q) expanding by 3.7%. Even the BoT is optimistic about the economy. This is reflected in the BoT's upward

revision to GDP growth for 2017 and 2018. The GDP forecast was raised to 3.8% for both 2017 and 2018 from 3.5% and 3.7% respectively. The BoT expects growth to come from external demand (tourism and exports) and gradual pick-up in domestic demand. We are as sanguine about the economy as the BoT. We believe the synchronize export recovery in the region should continue to lift export demand and keep growth supported. Already exports and imports have gained 7.5% and 15.3% y/y in the Jan-Jul period, highlighting the export-led recovery and the pick-up in domestic demand. In addition, the government's infrastructure push, including transport networks and the Eastern Economic Corridor should lift government spending further and also private investment. Our economic team maintains its full-year growth forecast for 2017 and 2018 at 3.8% respectively.

- **Headline inflation** rose by 0.32% y/y in Aug, accelerating from Jul's 0.17%. This marked the second straight month of positive inflation. Driving consumer prices higher was transport cost, which rose 2.1% y/y in Aug from 0.73% in Jul even as food prices slipped deeper into negative territory in Aug (Aug: -0.92% y/y vs. Jul: -0.55%). Core inflation however rose more moderating, rising by 0.46% y/y in Aug from 0.48% in Jul. For the Jan-Aug period, headline inflation still averaged 0.6% y/y, well below the BoT's target of 1-4%. Despite the lack of traction in inflation so far, our economic team expects inflationary pressures to return later this year on the back of low base effects, higher energy/fuel prices, improving domestic demand amid a weaker THB. This should allow inflation to average 1.0% in 2017. This is in contrast to the recent downward revision by the BoT to their headline inflation to 0.6% and 1.2% in 2017 and 2018 respectively. The central bank expects modest increases in inflation ahead attributable to a domestic demand recovery, excise tax increase and regulation on immigrant workers that could affect wages.
- **Monetary Policy Forecast:** The BoT continued to maintain the status quo in monetary policy, leaving its benchmark policy rate - the one-day repo rate - unchanged at 1.50% for the past 19 months. The last time the policy rate was lower than the current 1.50% level was during the Great Financial Crisis in 2009 when the rate was lowered to a historic low of 1.25% to support growth and maintain financial stability. The rationale for holding policy steady at its 27 Sep meeting was the BoT's optimism over domestic growth amid benign inflationary pressures. The BoT decision was a rebuff of the recent government pressure on the central bank for policy easing. Instead the BoT believes that a rate cut could increase financial stability risks.
- Unlike in its previous statements, the BoT did not appear to be as concerned about the recent THB strength. In its recent policy statement, the BoT acknowledged that the strength of the THB could be attributed not only to USD weakness but to the kingdom's current account surplus. It also highlighted that the THB movement vis-à-vis its trading partners was largely unchanged. The change in tone could be due to the rebound in the USD that is lifting the THB higher currently. Still, the central bank said that it would continue to closely monitor developments in the foreign exchange market. We also think

that the central will continue to consider extra measures to limit speculation in the THB, including further cuts to its bond issuance, particularly short-dated bonds as it had done before.

- **Latest Fiscal and External Balance Outlook:** The excise tax on alcohol and cigarettes has been increased effective 16 Sep. The tax on alcohol will rise by up to THB30/bottle, while beer will rise by THB0.50/can and THB2.66/bottle. Tax on imported wine will increase by THB110/bottle. Cigarettes will see increases of THB2 to THB15/pack. According to the Ministry of Finance Director-General Somchai Poolsavadi said that exercises tax revenue will increase by 2% under the new regime, generating about THB12bn in tax revenue. At the same time, the cabinet has approved an investment budget worth a combined THB2tn for 55 state enterprises in FY2018 on 26 Sep, a marked increase from THB580bn in FY2017. Infrastructure and logistics projects will receive the bulk of the investment budget of THB796bn of the total investment. Projects earmarked in the investment budget include the expansion of a natural gas pipeline (worth THB28.8b); expansion of Suvarnabhumi airport (worth THB18.1b); the Orange Line (eastern section) connecting Thailand Cultural Centre with Min Buri (worth THB19.1b); and the Red Line (Bang Sue-Rangsit) (worth THB17.8b).
- After widening to THB145.61bn in Jun, the current account surplus narrowed to THB93.43bn in Jul. This slippage was due to the narrower trade surplus in the trade account of THB45.36bn (vs. Jun's THB99.99bn). Details on the financial account are currently not available, but the surplus in the overall balance of payments (BoP) of THB78.03bn suggests that the financial account was again in deficit in Jul, possibly due to a deficit in the 'others' segment.
- **Key domestic events and issues to watch:** All focus will be on the Royal Cremation of the late HM King Bhumibol on 26 Oct with economic activities likely to take a pause a week ahead of the ceremonies.
- **Technical Outlook:** USDTHB rebounded into month-end, in line with our call. We shared that *signs are emerging that bearish momentum on weekly chart is waning while stochastics could be on the cusp of turning higher from oversold conditions*. Pair was last seen at 33.40 levels. We reiterate that sustained close above 33.40 (76.4% fibo retracement of 2015 low to high) may see the pair climb higher towards 34.30 levels (200 DMA). Support at 33 levels.

INR: Twin Deficits to Weigh

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDINR	65.00 (63.00)	64.50 (62.50)	66.00 (64.00)	65.00 (--)

Previous Forecast in Parenthesis

- Motivation for the FX View:** September has been a tale of two fortnights. The first two weeks of this month saw relatively strong data, with improving PMI figures as well as an accelerating inflation rate. The recent two weeks, however, has seen heightened worries on slowing economic growth, coupled with the large fiscal deficit that appears stretched for now. Even the previous Finance Minister Sinha felt compelled to publish an editorial, criticising incumbent Jaitley for the ‘mess’ in India’s economy.
- After the sharp run up in USDINR from under 64-handle to high of 65.89 (29 Sep), we see signs that stability maybe returning. But bias remains for USDINR to trade higher as twin deficit problems (widening of current account and large fiscal deficits) amid slowing growth momentum weigh in the rupee.
- In the first two weeks, economic growth appeared to have somewhat rebounded from the initial GST shock, with improved IP/PMI data compared to the previous period, though IP still came in below consensus. But the highlight(s) of the month came in the past 2 weeks or so, with multiple agencies cutting their forecasts for GDP growth this FY, all citing troubles caused by demonetisation and (more recently) GST. Investors have responded accordingly, with the USDINR climbing over 2% from 15 Sep to 28 Sep (64.0813 to 65.5087). Demand for equities remains weak - equity outflows have continued with a MTD outflow of -\$1.11bn (QTD outflow of -\$2.453bn) as of 27 Sep. Recent inflation prints came in higher than expected.
- Weak growth has been further amplified by the seeming lack of tools available to the government and RBI. Fiscal policy appears stretched right now. The government is grappling with a large fiscal deficit, and investors are worried that the government may be forced to exceed its 3.2% fiscal deficit target set earlier, which might worsen investor sentiment. The RBI announced a 25bps rate cut a few months back, but higher than expected inflation may discourage them from doing so again. Investors are only pricing in a 18.8% probability of at least one rate hike this year. Even restructuring appears to be moving at a slow pace, with Fitch saying that gross NPL ratio has reached 9.7% in FY17, up from 7.8% in FY16. Fitch has said that the government will have to ‘pump in more than double, even on a bare minimum basis, if it is to raise loan growth, address weak provision cover, and aid in effective NPL resolution’.
- We do not rule out further moves by the RBI, given the recent economic weakness. The Indian Express has reported that the

‘Finance Ministry expects the RBI to consider easing rates as it will help to ... promote economic growth’. Given the limitations on the fiscal budget, RBI may want to cut rate hikes for the second time consecutively to boost the economy.

- **Our Maybank vulnerability score** (using 9 economic and market variables: GDP, Yield, Politics, Current Account, Inflation, Fiscal, Equity Valuation, Population, Reserves) worsened to 4.8 (vs. 4.6) due to GDP and inflation.
- **Growth and Inflation Outlook:** IP (Jul) rebounded from -0.2% y/y in Jun to +1.2% in Jul, though it missed the consensus of +1.8%. The breakdown reveals a broad-based pickup in IP, with mining and electricity having higher growth by 0.5% each and electricity recording higher growth by 0.4%. Manufacturing PMI has also turned above 50 again in Aug (from 47.9 to 51.2), signifying that manufacturing is already signs of recovering after the sudden introduction of the GST earlier (Markit: ‘suppliers and their clients have become more knowledgeable of the GST rates’). The overall Markit report was broadly positive, though they warned that ‘there were signs of strains on manufacturers’ operating capacity’.
- However, there has been increasing concerns that India may not be able to sustain its current growth trajectory. Multiple organisations have cut India’s growth forecast for this year, citing the rushed demonetisation late last year and the equally rushed introduction of GST. OECD has cut their forecast from 7.3% to 6.7%, ADB from 7.4% to 7.0%, India Ratings from 7.4% to 6.7%. Many news sources are also citing rumours that India is planning to widen its fiscal deficit from -3.2% to -3.7% of GDP to stimulate the economy, but this may be difficult given India’s large deficit at the moment (Finance Ministry has committed to its -3.2% deficit but markets may not be fully convinced). Even Finance Minister Jaitley has acknowledged the tough balancing act of ‘continuing to spend in an economy’ while maintaining a ‘standard of fiscal prudence’. PM Modi has set up an independent Economic Advisory Council to advise the PM on India’s economic issues, including growth.
- Inflation again surprised to the upside and accelerated from the previous month, coming in at +3.36% for Aug (exp. 3.24%, prev. 2.36%). Inflation was led by food and beverage prices, which rose 1.96% y/y in Aug. This lifts CPI closer to the 4%-medium term target but nevertheless leaves some room for RBI to cut rates.
- Trade volume continued to pick up, though the trade balance slipped further into deficit in Aug. Bloomberg economists had forecast a slide narrowing of deficit to -\$11.2bn, but it instead slipped to -\$11.6bn. Exports grew 10.3% y/y in Aug (prev. 3.9%) while imports grew 21.0% y/y (prev. 15.4%). The recent weakening of the INR, however, may help to support trade in the months ahead.
- **Monetary Policy Forecast:** RBI delivered a 25bps rate cut on 2 Aug with only 2 out of 6 dissenters - one of whom (Dr. Ravindra H.Dholakia) urged for a 50bps rate cut. Most of the MPC members noted that inflation prints have come off while investment growth remains weak. That said, many are still wary of the upside risks to headline inflation in the months ahead and that explains the 25bps

cut rather a 50bps one. This was justified by the firmer-than-expected inflation print that came out earlier this month. CPI came in at 3.36% vs the previous 2.36%. WPI came in at 3.24% y/y vs the previous 1.88% (exp. 3.20%). We look for another rate cut later this year - likely to be in Dec rather than Oct as the MPC pauses to observe the inflation trend before acting. Risks to inflation are skewed to the upside with the HRA, fading base effects and upside food pressure underpinning though good monsoon rainfall, stable international commodity prices could keep key price drivers in check. Markets are pricing in (OIS-implied) a 17.1% probability of a rate cut in October, with a 18.4% probability of exactly one 25bps rate cut by the end of the year (2 meetings to go).

- The focus of this month is on flagging Indian growth. The Indian Express has reported that the 'Finance Ministry expects the RBI to consider easing rates as it will help to ... promote economic growth'; however, OIS market data implies markets are pricing in only a 17.1% probability of a rate cut on the upcoming 4th October meeting. Local news sources also announced recently that RBI would raise foreign investment limits for governments bonds effective as of 3rd Oct, as existing limits are close to being reached.
- **Latest Fiscal and External Balance Outlook:** Worries about the fiscal deficit have resurfaced amid slower growth. The Finance Ministry has recently said that they are committed to meeting the 3.2% fiscal deficit target for this year, though there is scepticism in the market. This was after local news sources reported rumours that the government was planning on increasing the deficit from 3.2% to 3.7%, in a bid to stimulate the economy. Economic Affairs Secretary Garg has said that the government 'does not foresee extra borrowing at this point in time, but we (the government) are conscious there may be a possibility'. However, breaching the fiscal deficit target may have serious implications - investors may become more wary of Indian bonds and ratings agencies may look to downgrade India's debts. RBI has also increased foreign investment limits for government bonds (which are close to being reached), presumably giving the Finance Ministry room to manoeuvre by raising more money through the sale of government bonds.
- From last available data, current account deficit has widened to - \$14.3bn in 2Q2017 (from -\$3.4bn in 1Q2017), above (less negative deficit) expectations of -\$15.4bn. On the other hand, the financial account in 2Q2017 has recorded even greater inflows of direct investment (\$7.24bn vs \$5.00bn previously) and portfolio investment (\$12.45bn vs \$10.80bn previously), leading to overall financial account surplus increasing from \$3.0bn to \$14.0bn. Recent INR weakness meant that India has seen recent equity outflows of \$1.11bn this month as of 27 Sep, though foreign investors are still picking up Indian bonds with net purchases of \$364.1mn this month (as of 27 Sep 2017).
- **Key domestic events and issues to watch:** RBI meeting (4 Oct); trade (10 and 16 Oct); CPI, IP, Wholesale prices (12 Oct).



VND: Stable

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018
USDVND	22760 (--)	22730 (--)	22780 (--)	22700 (--)

No Change to Previous Forecast

- Motivation for the FX View:** USD has remained stable in recent months and we might not see a lot of volatility in the USDVND for the rest of the year. Deputy Head of SBV Nguyen Hoang Minh has said that remittances are forecast to rise 10% to \$5.5bn this year, and will ‘help keep the currency stable’. He also said SBV sees ‘no pressure on the dong to drop against the dollar at the end of the year’. For the month ahead we expect USDVND to remain confined to 22710 - 22740 range.
- High public debt may result in some downside risk for Vietnam, though recent growth figures are encouraging and may mean that the government will feel less pressured to stimulate the economy through fiscal policy. While inflation remains relatively well-managed, the current trend of increasing oil prices may discourage further expansionary monetary policy by the SBV. While FDI inflows may not be as high as the previous month, they are still growing at a substantial rate and will help to cushion the VND from external depreciation pressures. The continued trade surplus, particularly the upward revision of last month’s trade surplus by over \$1bn, will also help to support the VND.
- Growth and Inflation Outlook:** Aug PMI-mfg grew slightly from 51.7 (July) to 51.8 (Aug), which was noted by Markit to be the highest in ASEAN. Manufacturing has been solid however, growing by 10.5% in 1H2017 according to ADB. Industrial production also remains buoyant, growing 13.2% y/y in Sep (8.4% in Aug). Recently released figures by the government showed better-than-expected growth at 6.41% (exp. 6.10%) in Jan-Sep this year, meaning there is less pressure for the government to hit its lofty 6.7% target. However, we note that a few days before this data release, ADB had lowered growth forecasts from 6.5% to 6.3% (2017) and 6.7% to 6.5% (2018), citing lower mining and crude oil outputs. The flow of FDI continues, with registered FDI growth at 34.3% y/y in Jan-Sep this year (down slightly from 37.4% y/y in Aug). With VND likely less threatened by the USD, stable CNY also providing an anchor for the currency, price pressures are thus also concomitantly capped.
- In this environment and with plenty of FTAs in the pipeline, Vietnam may continue to attract foreign investors for its infrastructure development. In the meantime, Vietnam has been seeing double digit growth in visitor arrivals, although at a slower pace of 18.6% y/y in Sep vs 35.1% y/y in Aug. Trade surplus for September was at \$400mn, weaker than expected (exp. \$850mn). This was also significantly less than August’s trade balance of +\$1586mn (revised upward from +\$400m). However, overall trade volume is still experiencing high

double digit growth with faster growth in exports (+19.8% y/y) and imports (+23.1% y/y). Retail sales rose to 10.5% y/y (Jan-Sep) from previous 10.3% (Jan-Aug), buoyed by strong tourist receipts.

- Recently, PM Nguyen Xuan Phuc has urged all government agencies, ministries and localities “to have more drastic efforts and solutions” to meet the growth rate of 6.7% for 2017. In order to do that, the economy must grow by at least 7.42%. That was also a reason why SBV had reduced its policy rates last month. As highlighted by our Macro Strategist, Dr. Chua Hak Bin, the focus on China-style point target, set at 6.7% for 2017, via pushing credit growth (already at +20%) could risk worsening NPL problems and weaken bank balance sheet.
- Inflation rose slightly to +3.40% y/y from previous 3.35% y/y (in line with expectations), driven by a faster rise in housing and constructions materials prices (4.85% y/y in Sep vs 4.23% in Aug) as well as in transport (6.69% y/y in Sep vs 5.67% in Aug). ADB has also revised Vietnam’s inflation forecast upwards for 2017 from 4.0% to 4.5% (still under the government’s target 5%), due to recent rate cuts and strong growth. Strong oil prices in recent months may have contributed to recent inflation gains (eg. in transport), though with USD less threatening before and concomitant less depreciation pressure on the VND, the inflation trajectory could remain benign for the rest of the year and remain on track to stay below the government-mandated 5%.
- **Monetary Policy Forecast:** SBV cut its official policy rates in Jul, reduced the annual refinancing rate by 25bps to 6.25%, rediscount rate from 4.5% to 4.25% and overnight electronic interbank rate and rate of loans to offset capital shortage in clearance between the SBV and credit institutions (from 7.5% to 7.25%). The absence of USD strength was able to cap inflation and allowing more room for the central bank to boost credit growth at home. SBV had said that the cut was meant to “support business and economic growth”. We also recall that the National Assembly passed a resolution on 21 Jun that allows bad debt to be bought and transferred with special bonds into bad debt at market prices under the guidance of the SBV. This move might be also one that could ease up credit conditions so that the resolution on NPL could be more easily executed. In the meantime, the cut in policy rates have triggered commercial banks to lower its deposit rates to retain their Net Interest Margin (NIMs). With USD remaining on a sluggish trend, USDVND could remain at the current range and that could actually be conducive for foreign investment. As of Apr, total outstanding credit rose 20%/y. Credit growth in the first 7 months could reach 9.3% according to the National Financial Supervisory Commission.
- **Latest Fiscal and External Balance Outlook:** Several local news sources have reported that the Vietnamese government has asked the Ministry of Finance to postpone several tax hikes, including an increase of VAT from 10% to 12%, in a move to hit the 6.7% growth target. Vietnamnet had previously estimated the VAT hike alone could increase budget revenue by \$3.1bn. This may hamper efforts by the government to reduce the budget deficit. The ADB has also highlighted that the government’s recent attempts to cut the budget

deficit were mainly through reducing capital spending, which may 'erode Vietnam's long-term growth performance'.

- Finance Minister Dinh Tien Dung assured previously that the government continues to aim for balanced budget in the long run. The state budget collection met 63% of the annual target this year (Jan-Aug data).
- Vietnam set a lower budget deficit of 3.38% of GDP for 2017 from previously 3.50%. 2016-18 public debt (including government debt, debt guaranteed by government, municipal debt) is capped at 65% of GDP. ADB has warned that public debt has reached this 65% limit. 2016-18 government debt is set at no more than 54% of GDP while foreign debt is set at no more than 50% of GDP.
- The government has an ongoing effort to divest VND67trn from SOE in the years leading to 2020. Key use of the capital is to develop important infrastructure projects like the Long Thanh International airport, along with the recent plans to build the Chrey Thom Bridge that will connect the southern province of An Giang in Vietnam to Cambodia's Kandal province. This is meant to promote bilateral trade and bring about more economic benefits for those communities along the border areas though a time frame was lacking. However, VietnamNews highlighted in mid-Sept that an official from the Ministry of Finance has acknowledged that equitisation in Vietnam has been slower than expected. It was highlighted that the 'rate of State capital is still high because the amount of publicly offered shares was low compared with corporate equitisation'. The Ministry of Finance has also said that of the 34 SOEs who received approval for equitisation this year, only 11 have completed this process.
- Current account recorded a deficit of U\$1.169bn in 1Q (latest data available), just as we have expected, deteriorating from the surplus of U\$155mn seen in 2016 4Q on the back of net U\$26mn trade deficit of goods and net U\$600mn trade deficit of services in addition to the net primary income payment of U\$2.38bn. That said, the financial account recorded a net inflow of U\$3.745bn. External trade balance continues to record deficit for 2Q though that could be partially offset by a more positive portfolio inflow seen for the quarter. Current account may continue to record a deficit in this quarter.
- **Key Domestic Events and Issues to Watch:** PMI-mfg is due on 2nd Oct. CPI is due on the 24th. 3Q GDP, Oct trade balance, industrial production and retail sales within 25-31st.

FX Forecasts

	End Q4-17	End Q1-18	End Q2-18	End Q3-18	End Q4-18	End Q1-19
USD/JPY	115	115	117	116	116	118
EUR/USD	1.2000	1.2000	1.1800	1.2100	1.1900	1.1600
GBP/USD	1.3200	1.3200	1.3400	1.3600	1.3800	1.4000
AUD/USD	0.7800	0.8000	0.8100	0.8300	0.8500	0.8500
NZD/USD	0.7300	0.7400	0.7500	0.7600	0.7600	0.7600
USD/SGD	1.3500	1.3550	1.3650	1.3700	1.3700	1.3750
USD/MYR	4.2500	4.2750	4.2000	4.1500	4.0500	4.0000
USD/IDR	13600	13600	13700	13650	13650	13300
USD/THB	34.00	34.00	34.30	34.80	35.00	35.00
USD/PHP	52.00	52.00	51.80	51.50	51.00	51.00
USD/CNY	6.60	6.60	6.65	6.60	6.55	6.50
USD/HKD	7.80	7.80	7.80	7.80	7.80	7.80
USD/TWD	30.60	30.60	31.00	30.80	30.50	30.00
USD/KRW	1160	1140	1140	1130	1140	1120
USD/INR	65.00	64.50	66.00	65.00	65.00	64.00
USD/VND	22760	22730	22780	22700	22500	22400
DXY Index	93.34	93.11	94.04	92.34	93.03	94.49
SGD Crosses	End Q4-17	End Q1-18	End Q2-18	End Q3-18	End Q4-18	End Q1-19
100 JPY/SGD	1.1739	1.1783	1.1667	1.1810	1.1810	1.1653
EUR/SGD	1.6200	1.6260	1.6107	1.6577	1.6303	1.5950
GBP/SGD	1.7820	1.7886	1.8291	1.8632	1.8906	1.9250
AUD/SGD	1.0530	1.0840	1.1057	1.1371	1.1645	1.1688
NZD/SGD	0.9855	1.0027	1.0238	1.0412	1.0412	1.0450
SGD/MYR	3.1481	3.1550	3.0769	3.0292	2.9562	2.9091
SGD/IDR	10074	10037	10037	9964	9964	9673
SGD/THB	25.19	25.09	25.13	25.40	25.55	25.45
SGD/PHP	38.52	38.38	37.95	37.59	37.23	37.09
SGD/CNY	4.89	4.87	4.87	4.82	4.78	4.73
SGD/HKD	5.78	5.76	5.71	5.69	5.69	5.67
SGD/TWD	22.67	22.58	22.71	22.48	22.26	21.82
SGD/KRW	859	841	835	825	832	815
SGD/INR	48.15	47.60	48.35	47.45	47.45	46.55
MYR Crosses	End Q4-17	End Q1-18	End Q2-18	End Q3-18	End Q4-18	End Q1-19
EUR/MYR	5.10	5.13	4.96	5.02	4.82	4.64
JPY/MYR	3.70	3.72	3.59	3.58	3.49	3.39
MYR/HKD	1.84	1.82	1.86	1.88	1.93	1.95
MYR/CNY	1.55	1.54	1.58	1.59	1.62	1.63
GBP/MYR	5.61	5.64	5.63	5.64	5.59	5.60
AUD/MYR	3.32	3.42	3.40	3.44	3.44	3.40
NZD/MYR	3.10	3.16	3.15	3.15	3.08	3.04
MYR/IDR	3200.00	3181.29	3261.90	3289.16	3370.37	3325.00
MYR/INR	15.29	15.09	15.71	15.66	16.05	16.00

Source: Maybank FX Research as of 2 Oct 2017

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

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