Macro | FX Research & Strategy

Global

FX Monthly

2018, Issue 9: Focus Shifts Towards Europe & UK

What Has Changed This Month?

- We look for EM Asia FX to strengthen from current levels although we calibrated some of the USDAXJs forecasts according to recent developments. CNY is forecast to strengthen towards 6.80 (vs. previous 6.72) against the USD as we look for the trade war premium to fade into the mid-term elections though narrowing CGB-UST yield spread continues to support this pair.
- AUD and NZD have also been revised lower to take into account widening yield differentials with the USD.
- USDMYR forecast has been revised higher due to carry allure waning on narrowing interest rate differentials and some domestic risk premium priced in.
- USDTHB has been downwardly revised on account of healthy growth momentum, return of foreign interest in Thai debt, expectations of BoT policy normalisation and possible shift in manufacturing away from China to Thailand.

Our Strategies

- We continue to favour positioning ahead for ECB-Fed policy convergence, given that Fed tightening may already be priced in while markets may potentially run the risk of "under-expecting" ECB's future policy normalisation trajectory. In the near term, the month ahead has a number of events including UK conservative party conference, German Bavarian State Election and Italian Budget Draft Submission to the EU that could keep EUR soft. Bias to accumulate EUR on dips.

- Stretched positioning suggests that certain currencies could be vulnerable to short squeezes including AUD and NZD, albeit within broader downtrends.

- The latest 10% tariff slapped on U$200bn Chinese imports by the US would be raised to 25% on 1st Jan. Between now and then, there could be a window of opportunity for EM Asia FX to recover against the USD. After all, net long USD positions is at 16-month high, EM Asian economies have adjusted policies and imposed stabilizing measures and much of the US-China trade war concerns could already be in the price. In an environment of rising rates, those currencies in rate hike cycles could outperform including IDR, SGD, PHP and THB.

Analysts

Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com.sg

Fiona Lim
(65) 6320 1374
fionalim@maybank.com.sg

Christopher Wong
(65) 6320 1347
wongkl@maybank.com.sg

Leslie Tang
(65) 6320 1378
leslietang@maybank.com.sg

Key FX Forecast Revisions

Upward	Downward
THB	CNY, MYR, EUR, GBP, AUD, NZD, INR, VND

Top 3 Currency Plays for October

Bias to Buy EUR on dips towards 1.14-1.15 levels for move towards 1.20
Accumulate USD, EUR against AXJ FX
Long IDR, PHP, SGD, THB against the USD

Key Events for the Month Ahead

Date	Event
30 Sep - 3 Oct	UK Conservative Party Conference
5 Oct	RBI Meeting
8 - 12 Oct	MAS Policy Announcement
14 Oct	German Bavarian State Election
15 Oct	Italy Budget Draft to be submitted to EU
18 - 19 Oct	EU Summit which would include discussion on Brexit

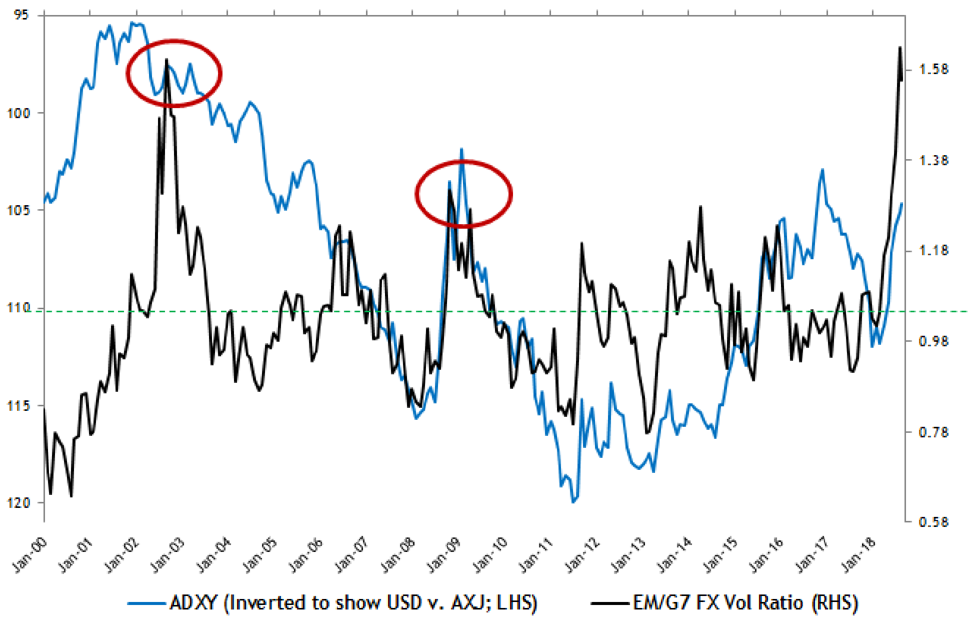
FX Sensitivity to Themes That Have Been in Play

Overlaying the three market dynamics, **CNH, INR, AUD and NZD** are consistently most sensitive when the three themes are in play.

	US-China Trade Tensions	EM FX Sell-off	Monetary Conditions
Most sensitive	CNH	NZD	INR
	KRW	INR	NZD
	AUD	AUD	AUD
	NZD	IDR	IDR
	INR	CNH	CNH
	THB	TWD	PHP
	SGD	THB	CHF
	CAD	KRW	CAD
	TWD	MYR	TWD
	IDR	PHP	KRW
	MYR	SGD	THB
	PHP	CAD	MYR
	CHF	JPY	SGD
Least sensitive	JPY	CHF	JPY

Note: From a statistical perspective, we regress selected FX including Asian, antipodeans and safe haven proxies) with trade war tensions (CNH as proxy), EM FX sell-off (BATS FX as proxy) and monetary conditions/Fed's hawkish rhetoric (UST 2Y treasury yield as proxy) and rank these currencies in order of their respective sensitivity.

Snapback in EM/G7 FX Vol Ratio May Lead to Further Recovery in AXJs



Source: Bloomberg, Maybank FX Research & Strategy

G7 Global Overview

USD: US Long Term Growth Concerns Emerging

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USD Index	94.15 (93.50)	93.52 (92.87)	92.69 (91.69)	90.58 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We are maintaining our view for some USD softness over the next 3 months as speculative USD longs are at risk of unwinding and fatigue sets in for USD bulls as EM risk premiums look overstretched. In addition, we see further stabilisation in the BTP-Bund Spread which is supportive of EUR strength for remainder of 2018. This was especially supported by comments on 24 Sep, by ECB President Mario Draghi who said in introductory remarks at a hearing on economic and monetary matters in the European Parliament that he expected a "vigorous pick-up in underlying inflation," even though harmonized eurozone headline inflation was likely going to be flat until 2020. Overall, we made some minor downward adjustments to the euro (Brexit and Italy larger than expected budget deficit) and GBP (Brexit negotiations entering a crucial volatile phase) to reflect recent market movements.

- Generally, the USD softened in Sep 2018. The run-up in USD strength since Apr 2018, on the back of US data outperformance, Fed's hawkish rhetoric, re-escalation of US-China trade tensions and EM FX sell-off has started to show signs of moderation, of late. But we stress that some degree of differentiation is needed when interpreting USD strength. DXY (or dollar index), commonly referred as the dollar proxy has fallen by 2% since mid-Aug and this was largely due to the recovery in the EUR and GBP (both made up nearly 70% of the DXY). This can be attributed to some clarity on Italy budget and renewed hopes that a Brexit deal is within reach. However the same cannot be said for USD vs. Asian FX which the USD has continued to trade near recent highs amid lingering concerns of trade tensions re-escalating and spill-over risk from the sell-off in BATS FX (Brazilian Real, Argentine Peso, Turkish Lira and South African Rand) which sparked fears of contagion. Higher UST yields in the lead up to upcoming FoMC meeting may be an additional factor (tightening monetary conditions) keeping the USD strength broadly supported.

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

- Fear of Fed picking up pace of tightening could lead to higher rates and keep USD supported in the interim. In particular recent Fed speaks seemed tilted towards the hawkish spectrum. However a dovish guidance from Fed may catch markets off-guard and see USD strength and UST yield taper off. This should provide a breather for risk assets and high-beta FX. Recall that Powell's comments (no clear sign of inflation accelerating above 2%... gradual hikes likely appropriate if growth stays strong… there doesn't seem to be elevated risks of overheating) at Jackson Hole Symposium (24 Aug) suggest that gradual pace of tightening remains the appropriate policy stance for now and there was no indication of a step up in the pace of normalisation.

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

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

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

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

- Synchronous global economic recovery, led by US, EU remains intact and it may be too soon to judge if recent inflation upticks could gather pace sustainably to warrant a shift for faster pace of rate hikes. As such we maintain our bias for broad USD downtrend and look for opportunities on USD upticks to fade into. We believe that a slightly faster pace of tightening amid healthy economic growth outlook and optimistic corporate earnings outlook should not derail the growth momentum or USD down-trend. That said the interim risk-off sentiment could remain as markets adjust from a period of policy certainty under Yellen's era to a period of policy uncertainty under a new leadership (Powell) and under the Trump administration.
- To add further on the USD inverse relationship with global trade and economic growth is that a large share of international trade is transacted in USD even when the US itself is not the party to the transaction. This suggests that world trade volumes are driven in large part by USD. Appreciation in the USD crimps demand for US exports but also for all USD-denominated exports.
- Developments in US trade relations with China, Europe and NAFTA in coming months will be crucial. But it will be hard to forecast its schedule with certainty and its impact as the scenarios are multiple fold. In the meantime, markets are likely to price the trade war risk premium with greater certainty at the moment since June.

- **Growth and Inflation Outlook:** US real GDP increased 4.2% y/y in 2Q 2018, the same rate of increase as in the "second" estimate. The updated estimates reflected more consumer spending on goods, more investment by state and local governments, and less spending on imports, which are a subtraction in the calculation of GDP. These upward revisions were offset by less inventory investment.
- The personal consumption expenditures (PCE) price index increased 2.0% in 2Q, a 0.1 percentage point increase from earlier estimates. Excluding food and energy prices, the PCE price index increased 2.1%, also revised up 0.1%. The leading contributor to the upward revision was health care prices, based on revised producer price index data from the Bureau of Labor Statistics.
- The August CPI headline CPI rose 0.2% m/m and core CPI was up 0.1% m/m. The annual pace of headline CPI slowed to 2.7%, and core CPI also fell to 2.2%.
- The weaker-than-expected headline reading was mainly a result of softer core CPI but energy and food prices were broadly as expected. Food prices rose modestly, at 0.1% m/m. But softer domestic farmer prices suggests the softness in the food at home category is likely to continue in the coming months. The increase in energy prices was broad based across energy commodities and services. At the core level, goods prices fell as a result of a sharp drop in apparel prices and some weakness in medical care commodities. Core services inflation was in line with its recent trend, with shelter and airfares providing strong support. Since we continue to expect the US economy to continue to grow at an above-trend pace and spare capacity in the economy to be used. This should continue to lead to a modest overshoot of inflation above the Fed's 2% target. However, recent USD strength could weigh on inflation.

- With US activity growing strongly in the wake of fiscal stimulus, and risks to the inflation and employment outlooks seemingly balanced for now, the Fed remains on course to keep rates on a gradual upward move. In our view, there is little in the latest labor market data to suggest that it should slow or pause rate hikes, and there has been little in the inflation data that points to a significant overshoot of the 2.0% target. Gradual rate hikes are likely to be seen as balancing the risks of going too slow against those of hiking too fast.

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

- The Fed raised the target range for the federal funds rate by 25bp, to 2.0-2.25%, as widely expected. The FOMC continues to have a positive view of the effects of fiscal policy on economic activity and the US economy's ability to withstand shocks. The Sep statement continued to describe the economy as "strong."

- In the updated set of economic projections, the committee raised its 2018 growth forecast and the estimate of the long-run funds rate to 3.0%, from 2.875%. The remainder of the outlook remained largely unchanged and, as a result, there was no change in the median policy path. The committee expects the median funds rate to rise to 2.4% in 2018, 3.1% in 2019, and 3.4% in 2020. Twelve of 16 committee members see the outlook as consistent with another hike before year-end.

- The FOMC also removed the language that said monetary policy "remains accommodative" thus somewhat confirming that members expect monetary policy to become restrictive over time. Economic projections for 2021 include growth slowing to potential and a rise in the unemployment rate to 3.7% from 3.5%.

- During the press conference, Chairman Powell indicated that the Fed will likely have to conduct policy more on feel and less on a model-based forecast which in our view could leave room for timing inconsistencies if policy lags take some time to feed into the economy. Markets interpreted Chairman Powell's comments as somewhat dovish but Powell's dismissal of the language change as meaningful, and focused instead on how the Fed views the economy after the initial gains of fiscal stimulus. The Fed sees growth in 2021 decelerating to the long run level and it shows the unemployment rate increasing in 2021. Overall, more Fed officials targets for rates was lower for 2020, but the median did not change suggesting a not too positive picture beyond 2020.

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

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

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

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

- **Key domestic events and issues to watch in Oct 2018:** ISM Mfg (1 Oct); FOMC (2 Aug); FOMC meeting minutes (23 Aug); Factory orders and Durable Goods Orders (4, 25 Oct), NFP (5 Oct); Trade balance (5 Oct); CPI (11 Oct); Retail Sales (15 Oct); Housing Starts (17 Oct); GDP 3QA (26 Oct); Core PCE (29 Oct); PCE Deflator (29 Oct).

- **Technical Outlook:** Our call (in last month's FX Outlook) for DXY to head lower met 2 out of 3 of our objectives. DXY traded a low of 93.81 (21 Sep). Our final and stretched objective at 93.2 was not met. Nonetheless DXY was last seen at 94.50 levels. Bearish momentum on daily chart show signs of waning while stochastics shows signs of rising from oversold conditions. A bullish divergence appears to be forming on the daily chart. A falling wedge also appears to be forming. These technical patterns typical signal the risk of rebound in the near term. Rebound may test 95 levels (38.2% fibo retracement of Aug high to Sep low, 50 DMA), 95.70 levels (61.8% fibo). Underlying bias remains to sell on rally. Weekly momentum remains bearish. Support at 94 levels, 93.80 before 93.2 over an extended period.

EUR: Possibly Entering Choppier Waters but Bias to Accumulate Remains

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
EURUSD	1.1800 (1.1900)	1.1900 (1.2000)	1.2000 (1.2200)	1.2200 (1.2300)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** For the month ahead, we **expect vols to pick up and EUR to trade in choppy range** of 1.15 – 1.19 amid a confluence of events that could prove sensitive for the EUR: (1) the lead up to German Bavarian state election on 14 Oct; (2) Italy budget details will be submitted to EU for approval by 15 Oct; (3) if US-China trade tensions further re-escalates and broadens to US-EU; (4) Brexit progress backtracks (5) Fed to signal a faster than expected pace of tightening. Nonetheless these factors serve as caution (pullback risks) and do not alter our constructive view of the EUR or signal a change in our bias to accumulate on dips. Support levels at 1.15-1.16. We expect EUR to test 1.1850 in coming weeks. On forecast changes, we calibrate EUR forecasts lower to take into account hard-brexit risks given that progress is still limited amid tight brexit timeline.
  - **Ongoing trade war between US and China** may have been one of the "culprits" starting to impact business decisions, trade numbers and specifically the auto industry. Europe's net trade turned negative for 2Q while manufacturing activity grew at its slowest pace in 2 years. According to Markit, the auto industry is taking the brunt of the slowdown. Further escalation in trade tensions could put global supply chain at risk and disrupt demand. This could pose downside risk to the EUR;
  - **Italy budget should see further visibility in coming days.** Economy Minister Tria is said to be targeting a budget deficit of -1.9% of GDP (this should sit quite comfortably with the EU) but the coalition parties are looking for a deficit of 2.4 of GDP. We should expect further details soon before final budget draft (with targets) is made known and submitted to EU for review by 15th Oct. The final budget has to be ratified by Italian parliament by end-2018. More clarity (less of clash with EU) should see BTP-Bund yield spread narrow. Further narrowing in yield spread should help to consolidate EUR strength;
  - The lead-up to German Bavarian State election (14 Oct) may see heightened political uncertainty German Chancellor Merkel could be at risk of losing powers if Christian Social Union (or CSU, the sister party to Merkel's CDU party and coalition partner) loses the election to right wing AfD. Rise in populism undermines the Euro-club; heightens political uncertainty and this may pose downside pressure on the EUR.

- We **retain a constructive outlook on the EUR in the medium term** on a combination of factors including: (1) monetary policy convergence possibly towards the turn of the year (ECB-Fed policy divergence likely to slow as Fed normalisation likely to have been priced in while markets start to price in ECB normalisation); (2) sustained price and wage growth pressure may result in ECB needing to normalize policies ahead of schedule; (3) stable growth momentum in Europe, looking past transitory factors in 1Q though trade tensions still warrant caution; (4) political and budget concerns in Germany and Italy to play out after Bavarian State election (14 Oct); (5) signs of progress between EU-UK with brexit negotiations. On the latter, we argue that a smoother and more predictable exit for UK should serve to mitigate uncertainty associated with business investments even for European companies and this should support the EUR.

- Our long-standing bias to accumulate (buy) EUR on dips continued to play out as EUR dipped towards 1.1526 (10 Sep), as cautioned in last month's FX Outlook before mounting an attack above 1.18-handle (24 Sep). Positive tone from ECB's Draghi, some progress with Brexit negotiations and some visibility on Italy's budget plans (as seen from the narrowing of BTP-Bund yield spreads by nearly 60bps from +290bps to 233bps) supported the EUR. Taking stock of our contrarian 3Q EUR forecast of 1.17 (consensus was 1.15), which we have held since Jul FX monthly outlook, the current spot (last seen at 1.1720) looks on track to meet our 3Q forecast.

- **Growth and Inflation Outlook:** The latest ECB macroeconomic projection in Sep 2018 report shows that projections for 2018 and 2019 growth have been revised lower to 2% (vs. 2.1% in Jun's projection) and 1.8% (vs. 1.9% in Jun's projection), respectively. 2020 growth projection remains unchanged at 1.7%. **Though ECB forecasts showed that growth will ease slightly faster than previously anticipated, Draghi said that the underlying strength of the economy is solid enough to cope with global risks. He added that downside risks are going to be mitigated by the improvement in the labor market and rising wages.** Looking out, the ECB still expects growth to remain stable over the next few quarters, in line with elevated levels of business and consumer sentiment though real GDP is projected to trend gradually lower towards 1.7% in 2020 as tailwind gradually fades.

- **Euro-area economy expanded +0.4% q/q in 2Q** (vs. +0.3% in 1Q). Business and other investment rose sharply while net trade turned negative. Amongst the Eurozone nations, growth was weakest in France, Italy and Greece while growth was strongest in Malta, Estonia and Slovakia. 3Q GDP for Eurozone is likely to maintain a similar pace of growth as 2Q. Prelim PMIs for Eurozone (53.3), including Germany and France showed manufacturing activity continued to trend lower in Sep while services PMI for Eurozone (54.7) and Germany picked up in Sep.

- **ECB's inflation profile for the Eurozone remains flat at 1.7% for forecast horizon from 2018 - 2020**. Uncertainty around inflation outlook is receding and the ECB expects core inflation to pick up towards the end of 2018 and thereafter to increase gradually.

- **Both headline and core Euro-area inflation slipped modestly to 2% y/y in Aug (vs. 2.1% in Jul) and 1% (vs. 1.1%), respectively but is likely to be transitory. Sep inflation estimate (to be released on 28 Sep) is likely to post a re-acceleration.** Nonetheless we emphasize that current level of inflation has already topped ECB's sub-2% target and has validated our long-standing call for inflation to rise amid ECB's accommodative monetary policy stance, higher energy prices and wage growth (negotiated wages rose to 2.2% y/y in 2Q from 1.7% in 1Q and is expected to rise further as wage agreements often last 2 years or more). In a testimony to the European Parliament's Economic and Monetary Affairs Committee in Brussels (24 Sep), Draghi described acceleration **in underlying inflation in the euro zone as "relatively vigorous" and expressed confidence that a pick-up in wage growth would continue.** In a separate interview published on 23 Sep, Austrian central bank Governor **Nowotny said he would welcome moving the ECB's deposit rate towards -0.2% from current -0.4%. Other ECB heavyweights including Coeure and Praet said there the ECB would need to start clarifying the likely path of its interest rates beyond its first rate hike.**

- **Monetary Policy Forecast: APP at monthly pace of €30 billion will be reduced to €15 billion per month between Oct and Dec 2018.** We expect ECB to **keep monetary policy stance status quo at the upcoming ECB GC meeting (25th Oct)** following their move in Jun on timeline of APP reduction and forward guidance on rates. **ECB is expected to keep rates unchanged till Autumn 2019 (around Oct-Nov) but we continue to see risk that the ECB may need to move earlier than expected** (relative to ECB's timeline) should (1) inflation data, in particular core CPI continues to surprise to the upside while (2) growth and activity data continues to hold up. With global oil production unlikely to see further increases, oil prices could still stay supported and that has already tipped Euro-area inflation to overshoot ECB's inflation target of under-2%. Headline CPI was last at 2 % y/y (Aug). A weaker currency (YTD decline of 10% at one point vs. USD) could result in higher prices via the **import price channel**. This should add on to further upside pressure for Euro-area CPI. **We do not rule out the possibility that ECB could proceed with baby steps to normalize deposit rate first** (currently at -0.4%) at some stage.

- At the last ECB meeting (13 Sep), Draghi sounded upbeat about growth prospects. **He said that the underlying strength of the economy is solid enough to cope with global risks. He added that downside risks are going to be mitigated by the improvement in the labor market and rising wages. On forward guidance, he stuck to the script -** "key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term".

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

- **Latest Fiscal and External Balance Outlook:** Euro area's current account surplus narrowed to EUR21bn in Jul (vs. EUR24bn in Jun). This was due to slippage in goods surplus while services surplus rose. Current account surplus to GDP was last seen at 3.5%, for the 12-months to Jul. ECB expects current account surplus to narrow further to 2.8% of GDP in 2019.

- The EA19 government deficit narrowed to -0.9% of GDP in end-2017 (vs. -1% of GDP in 3Q). This is the narrowest level since 2008. Breakdown showed German government recorded +1.3% surplus of GDP while deficits were seen for France, Italy and Spain at -2.6%, -2.3% and -3.1 of GDP, respectively. Government debt to GDP also declined to 86.7% as of end-2017 (vs. 89% at end-2016).

- **Key domestic events and issues to watch:** Sep Mfg PMI (1 Oct); Aug PPI (2 Oct); Sep services PMI, Aug retail sales (3 Oct); Aug IP (12 Oct); German Bavarian state election (14 Oct); Oct ZEW survey (16 Oct); Aug construction output, Sep CPI (17 Oct); (17 Sep); Aug current account (19 Oct); Oct consumer confidence (23 Oct); Oct prelim PMIs (24 Oct); ECB GC meeting (25 Oct); 3Q final GDP (30 Oct).

- **Technical Outlook:** Our call (in last month's FX Monthly) for EUR to trade higher was met. Move higher notched a high of 1.1815 (24 Sep), slightly short of our stretched second objective of 1.1860. Pair was last seen at 1.17 levels. Daily technical suggests risk of pullback from recent highs. Support at 1.1620 (38.2% fibo retracement of Aug low to Sep high, 50 DMA) before 1.1560 (50% fibo), 1.15 (61.8% fibo). Bias to accumulate on dips. Bullish momentum on weekly chart remains intact. On price pattern, we highlighted an inverted head-and-shoulders possibly in the making (S1 at 1.1510; S2 at 1.1540; H at 1.13; neckline around 1.17 levels). The complete bullish reversal of the pattern should bring the pair back to 1.21 levels. Immediate resistance at 1.18, 1.1950 (200 DMA). We would review our bias should support at 1.15 be breached.

GBP: Brexit Entering Crucial Phase in Oct

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
GBPUSD	1.3200 (1.3400)	1.3000 (1.3200)	1.3400 (1.3500)	1.3500 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** Our call (in the last FX Monthly) for GBP to trade higher towards our technical target of 1.3290 was met. GBP traded a high of 1.3298 (20 Sep) and was last seen around 1.3130 levels. As of writing (27 Sep), current level of spot is within striking distance of our contrarian 3Q forecast of 1.32 (Bloomberg consensus was looking for 1.30). Looking ahead for Oct, we expect renewed volatility for GBP as Brexit deadline draws closer. 1m GBP vols may pick up further towards 10-handle (last seen at 8.9) while GBP may test lower towards 1.30-handle in the near term (on a wide range of 1.28 – 1.33) on brexit uncertainty. Progress on brexit development remains fluid, with optimism on the EU front fading after PM May rejected EU's offer while domestically, PM May continues to face challenges on her brexit plan. Given persistent uncertainties on Brexit in the near term, we revised 4Q and 1Q forecast lower but maintained trajectory profile into end-2019. Barring these short-term nuances driven by Brexit headlines, we continue to retain our cautious optimism on GBP's outlook, on the basis that UK will manage an orderly Brexit. (our base case remains for UK to strike a deal with EU at the eleventh hour while PM May remains in power and the cabinet divide narrows). We argue that any positive progress towards an agreement on Brexit could result in further unwinding of GBP shorts. Greater visibility and clarity on Brexit and PM May's leadership should support GBP. The recovery may even be amplified in the environment of renewed USD weakness.

- **Brexit Development on both the EU and domestic fronts are sources of uncertainties for the GBP.**
  - **On the Domestic front:** PM May could potentially face **leadership challenges** as Brexiters are apparently planning to oust her from the Premiership. The annual Conservative party conference (30 Sep – 3 Oct) would be closely watched and the slightest sign of confidence vote is enough to trigger a GBP sell-off. **Even within her Conservative party, there are deep divisions** and that makes it even more challenging for her to garner support for the Chequers plan. In addition, there are **deep division with the cabinet** as Labor party leader Corbyn has declared that Labour party would vote against a brexit deal based on PM May's proposal. At the recent Labor party annual conference, Corbyn sought to show that his party is ready to take over the reins of power, setting out in the most detail a radical plan to "build and transform our country";
  - **On the EU front:** PM May rejected EU's proposal on future trade which is believed to split England, Wales and Scotland from Northern Ireland (part of the UK) by insisting that Northern Ireland adhere to different customs rules. PM May signaled that she would prefer a no-deal Brexit than a poor deal (18 Sep). As of 27 Sep, EU is said to start exploring what emergency measures it may need to take without UK's cooperation in the case of no-deal brexit. These discussions were meant to take place behind closed doors and there is little information of that. We stress that headlines of no-brexit (even without much details) are sufficient to lead to sell-off in GBP.
- There are some key dates over the next 1 - 2 months to keep in view: (1) Conservative Party Conference (30 Sep – 3 Oct 2018) – watch out for risk of PM May's leadership being challenged; (2) EU Summit (18 – 19 Oct) will include a preliminary discussion on EU-UK future relationship; (3) potential extraordinary EU summit could occur in Nov,

depending on progress of Brexit discussion. We do wish to add that a official (declined to be named) added that that UK is willing to settle for a vaguer statement of intent on the future relationship, postponing some decision until after Brexit day. **To be sure, future trade deal need not be negotiated before UK formally exits on 29 Mar 2019; only the separation agreement needs to be negotiated before 29th Mar 2019 to avoid a disorderly exit.**

- **Downside Risks to Our Outlook:** (1) no-deal brexit (akin to hard brexit scenario) concerns if re-emerged will dampen confidence on GBP bulls; (2) Delay in finalising a deal heightens uncertainty (raises fears of disorderly brexit), dampen investor/business confidence and expose GBP to further vulnerabilities; (3) growing divide within PM May's cabinet and conservative leading to PM May's leadership being challenged is also another source of volatility for GBP; (4) slowing economic momentum including deceleration in wage growth, PMIs, IP will weigh on GBP.

- Into the medium term, we maintain our bias that GBP could trade higher. GBP is perceived to be undervalued from both historical and fundamentals perspective (our BEER model puts GBP at 1.40 – 1.45). The 20% or so depreciation in the Brexit-aftermath (from Jun to Oct 2016) should help the UK economy to rebalance and grow sustainably over time - current account deficit should narrow, exports should become more competitive and tourism and education receipts should pick up further. We hold to our belief that UK should be able to manage the exit, transform itself into a global marketplace and continue to attract capital (longer-term).

  - Past experience of UK leaving the ERM back in 1992 saw a period of consolidation (for a few years) at historical lows for GBP, before the eventual move higher in the following years, where GBP TWI traded above 100-levels in 1998 (from the lows of 80 in 1993-1996) due to buoyant demand fueled by rapid growth of wealth, credit and money. If history is a guide (assuming UK manages the transition well and takes the opportunity to correct its imbalances), its currency may start climbing higher.

- **Growth and Inflation Outlook:** As of the last Quarterly Inflation report (2 Aug), BoE MPC **expects GDP to grow by around 1.75% per year on average over the forecast period**. Net trade and business investment could continue to support UK activity while consumption grows in line with the subdued pace of real incomes. The MPC continues to judge that the UK economy currently has a very limited degree of slack. Unemployment is low (5.2%) and is projected to fall a little further. In the MPC's central projection, therefore, a small margin of excess demand emerges by late 2019 and this could feed through into higher growth in domestic costs than has been seen over recent years.

- 2Q GDP rebounded to +0.4% q/q (vs. +0.2% in 1Q). The rebound was attributed to the construction and services sectors (strongest quarterly expansion since end-2016 and accounts for nearly 80% of UK economy) thanks to hot weather following the cold snap in 1Q (which weighed on growth and activity). On PMI divergence, manufacturing and construction fell while services rose. Aug retail sales surprised to the upside (+0.3% m/m vs. -0.2% expected), helped by hot weather. Household goods such as furniture and electrical items rose while food and clothing fell.

- **UK headline inflation unexpectedly jumped to 2.7% y/y in Aug (vs. 2.5% in Jul)** led by clothing, sea fares and theatre tickets. This was the second back-to-back increase since Nov 2017 and the level remains well above BoE's 2% target. Core inflation also rose to 2.1% y/y (vs. 1.9%). Wage growth, on the other hand also picked up pace to +2.6% for Jul (up from 2.4% in prior month). Some argued that the trend of rising prices is temporary due to the volatile nature of the contributors - clothing, sea fares and theatre. We cautioned that the pick-up in core CPI, wage growth and rising oil prices may well keep the upward pressure on prices intact.

- **Monetary Policy Forecast: There is no scheduled MPC meeting for Oct. The next meeting is scheduled for 1 Nov. We expect BoE to keep policy rate unchanged at 0.75% for the rest of 2018.** Monetary policy stance is likely to remain status quo for as long as over the next 6 -9 months before the next rate hike as uncertainty over Brexit clouds normalisation. **OIS implied suggests the next rate hike could take place in May-2019 at the earliest** (59.2% probability). BoE's forward guidance shows another 2 hikes expected to end-2020. We remain watchful of inflationary pressures as tight labor market could generate domestic price pressures. Sustained rebound in CPI towards 3% again could change our view on BoE policy status quo (to front-load rate hikes). The size of BoE balance sheet (GBP435bn) is also expected to stay unchanged until policy rate reached 1.5% (this was discussed and agreed at the Jun BoE MPC meeting). The policy rate was last raised by 25bps at the Aug meeting.

- At the last BoE meeting on 13 Sep, MPC voted 9-0 to keep policy rate unchanged at 0.75%, as widely expected. MPC flagged "greater uncertainty" around Brexit negotiations but raised forecast for UK economic growth to 0.5% for 3Q (up from 0.4%) on potentially higher consumer spending over warm summer. Carney shared in a cabinet meeting (13 Sep) that the impact of no-deal Brexit could be as catastrophic as the 2008-09 GFC. According to media reports, Carney "painted a bleak economic picture of unemployment reaching double figures in percentage terms, house prices falling by 25-35% over three years, and transport links with the EU, including air travel and the Eurostar, stalling".

- **Latest Fiscal and External Balance Outlook:** UK's current account deficit widened to -3.9% of GDP for 2Q (vs. -3.4% of GDP in 1Q). Deterioration was due to widening of trade deficit. The Office of Budget Responsibility has projected current account deficit to be about -4.4% of GDP in 2021, rather than -2% of GDP initially forecasted in Mar 2017. Foreign inflow of capital is needed to fund the deficit. But if Brexit uncertainty takes a turn for the worse or persists for longer, investor/business sentiment can be adversely impacted. Slowdown in foreign inflows could worsen the situation and the GBP could come under pressure as a result.

- UK posted a much larger budget deficit for Aug owing to subdued tax receipts, contribution to EU's budget and state pension. Deficit for the 1st 5 months of the current financial year was down 30.5% from a year ago. Progress suggests the Chancellor Hammond is on course to undershoot the forecast deficit of 1.8% of GDP. Ultimately Hammond is targeting a budget surplus by mid-2020s, in order to cut national debt as a share of GDP, which he says, is too high to easily support a big rise in public spending during a future deep recession.

- Chancellor Hammond said Budget will take place on 29th Oct and he will set out the government's "balanced approach" in reducing debt and supporting vital services.

- **Key domestic events and issues to watch:** Sep Mfg PMI (1 Oct); Sep construction PMI (2 Oct); Sep services PMI (3 Oct); Sep house prices (5 Oct); Aug trade, IP, construction output (10 Oct); Aug labor market report (16 Oct); Sep CPI, PPI, RPI (17 Oct); Sep retail sales (18 Oct); Sep public finances (19 Oct); Oct consumer confidence (31 Oct).

- **Technical Outlook:** GBP traded higher for the month of Sep, in line with our call. Pair was last seen at 1.3130 levels. Daily momentum turned bearish while stochastics is falling from overbought conditions. Further downside not ruled out. Sharper move towards 1.2990 (50 DMA) not ruled out on decisive break below 1.3070 levels (lower bound of bullish trend channel, 21 DMA, 23.6% fibo). Weekly momentum remains bullish. Resistance at 1.3220, 1.3320 (38.2% fibo retracement of 2018 high to low).

AUD: Hurt By Rising Global Rates

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
AUDUSD	0.71 (0.75)	0.69 (0.76)	0.68 (0.78)	0.70 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** AUD is hurt by a central bank that does nothing and could remain penalized in a world of rising rates. With RBA unlikely to make a move in 2019 and the Fed looking to raise the FFTR by another 75bps in the same period, albeit with fed funds futures implying less than 50bps. It is hard for AUD to find favour with yield hunters even when risk appetite recovers. AUD has slowly lost its luster in a world of monetary policy normalization which stands a contrast to RBA which will not budge.

- To be sure, Australia does not have a weak economy. Hiring momentum is robust, private consumption is firm, private investment has been strong, capacity utilization rates are high. However, US-China trade war dampens global trade. AUD is one of the most sensitive currencies to the trade war and we reckon a huge part of the trade war is in the price. Upshot is that Australia is one of the top trading partners of China (6th largest in terms of 2017 total trade), upcoming tariff cut that China has planned could cushion some of its impact. At home, the decline in its real estate market could crimp on private consumption, not helped the least by the rise in the mortgage rates. So whilst the economy is robust, slower global growth and trade, softening property market that could translate to negative wealth effect limits the impetus to move rates. With AUD already down so much for the year, positioning matters. Net short positioning for the AUD is at its 42-month low according to CFTC and this could still render AUD vulnerable to short squeezes. However, the broad trend is still to the downside and we look for AUD to head towards 0.71 by the end of this year.

- **Growth and Inflation Outlook:**
  - 2Q GDP came in above the expected at 0.9% q/q, just a tad softer than the previous 1.1% (which was revised higher). Consumption maintained its pace with household consumption picking up pace in 2Q to 0.4%q/q from previous 0.6%, offsetting the deceleration in government expenditure to 0.2%q/q from 0.3%. With AUD not making much recovery yet, expect that to continue to support net exports subcomponent. We are not particularly bullish on the household consumption given tightening financial conditions and low wage growth that could crimp on disposable income. The rise in the money market rates prompted some major local lenders to raise their mortgage rates recently. However, inflation is still benign enough to support household consumption.

- Even as RBA did not raise cash target rate, financial conditions have been tightening for Australian residents and corporates with requirements for more collateral and APRA restrictions. Residential property price increase has been softening since the mid of last year with prices of houses in Sydney in contractions and prices of those in Melbourne also slowing in the second quarter. 3M BBSW slipped in Sep before edging higher to 1.935%. With the US still in the midst of hiking cycle and other DM central banks looking to normalize, expect risks to interbank rates to remain to the upside. Dwelling finance commitment for housing has been in contraction for the past 8 months, albeit the -5.1%y/y fall in Jul is smaller than the previous month.

- **As of last release, CPI** quickened to 2.1%y/y from previous 1.9%. The average of the trimmed mean and median was at 1.9%. Seasonally adjusted, the headline actually firmed to 2.2%y/y from previous 2.0%. Food inflation softened in the quarter but this was outweighed by the acceleration in transportation, recreation and education. Looking at the breakdown for goods and services, the CPI for goods seem to be on the uptick, possibly buoyed by the rise in energy prices as well as the cheaper AUD. With the drought affecting the agriculture output of the country, there could also be some upside risks to food inflation.

- **Monetary Policy Forecast:** We continue to expect RBA to keep cash target rates unchanged and we see an increasing possibility of the central bank standing pat throughout 2019. With the CPI still close to the lower bound of the 2-3% inflation target and plenty of uncertainty in the horizon amid the current trade war, there is very little motivation for the central bank to move rates at this point. RBA just published a study on wage growth puzzles and technology which has monetary policy implication. It finds that *the increasing impact of digital technology is certainly not the only factor that may be leading to increased competition in product markets and greater employer resistance to cost – including wage cost – pressures, but the anecdotal evidence suggest it is an important and growing one*. With consumption likely to remain subdued, inflation pressure could remain tempered. That could offset price pressure from a cheaper AUD.

- We note that RBA seems to be comfortable with the AUD at this point and even stated its expectations for terms of trade to "stay at a relatively high level". That said, RBA Lowe had said that the next move is still likely a hike rather than a cut and that somewhat protects the downside for the AUD. However, that rate hike might not come at all as wage growth remains subdued and as mortgage rates creep higher, leaving less room for RBA to lift rates at all.

- **Latest Fiscal and External Balance Outlook:** Budget deficit for 2018-19 was reported to be A$10.1bn by the new Treasurer Josh Frydenberg vs the projected A$14.5bn. In response, S&P upgraded its negative watch on Australia to stable, affirming the AAA rating of the sovereign. S&P is confident that Australia's budget would return to surplus and a property crash is less likely. The government projects a surplus of A$2.2bn in 2019-20, in line with market expectation. The outstanding Australian government debt is projected to be at A$533bn by the end of June this year and at A$561bn at the end of Jun next year. Thus net debt is forecast to peak at 18.6% of GDP in 2017-18.

- **Key domestic events and issues to watch:** MI inflation gauge for Sep on 1^{st} Oct; RBA meeting; building approvals for Aug on 3^{rd}; Aug trade data on the 4^{th}; retail sales on the 5^{th}; NAB business survey on Sep; Westpac consumer confidence on Oct; home loans for Aug on the 12^{th}; Minutes of the RBA meeting on the 16^{th}; labour report on the 18^{th}; building approvals on Sep and 3Q CPI on the 31^{st}.

- **Technical Outlook:** AUDUSD last printed 0.7210. This pair is still firmly within the trend channel and widening yield differentials suggest that this pair could head towards the 0.70 by the end of the year. Eye the 0.73-figure for a change in our view.

NZD: Bottoming Possibly but Unlikely to Take Flight

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
NZDUSD	**0.6500** (0.6800)	**0.6700** (0.7000)	**0.7000** (0.7200)	**0.7200** (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We still **hold to our view that NZD lacks fundamental catalysts from within to drive it meaningfully higher** as monetary policy divergence between Fed and RBNZ persists (Fed normalisation path intact vs. RBNZ's preference for easy policies into 2020), dairy prices remain soft and forward indicators point to potential slippage in activity momentum for 3Q. We revise our forecast lower to price in the above factors. However **we are also not of the view that NZD will free fall. We think a potential interim base could be forming around 0.64 - 0.65 levels but rebound may not take flight significantly higher.** True that US-China trade tension escalating is detrimental to risk sentiment and is negative for the NZD, plans of China lowering tariffs for major trade partners as early as Oct could serve as a mitigating factor. To some extent, it may even benefit the NZD directly (no further details on tariff decision as of now). In addition, NZD shorts (as seen from CFTC positioning) are at record levels. Any unwinding on recovery in sentiment could force an abrupt short squeeze for NZD. We are still looking for opportunity to buy on dips towards 0.65 levels, looking for short-term rebound towards 0.67, 0.68 levels (next 2 – 4 weeks).

- Our recent study on FX sensitivity of selected currencies to market dynamics including US-China trade tensions, EM FX sell-off and monetary conditions show that NZD ranks amongst one of the most sensitive FX. While it is true that NZD suffers if those conditions worsen, we wish to add that NZD may see a sharper recovery in the event US-China trade tensions de-escalates, EM sell-off recovers or global monetary conditions ease, given that NZD short is overstretched at present.

- It is interesting to note that actual 2Q GDP accelerating is in sharp contrast to RBNZ's projection of 2Q GDP dipping further to 2.3% before recovering to 2.5% in 3Q. While RBNZ had mentioned (Assistant Governor McDermott's speech here) that forecasting is a valuable part of the monetary policy process, helping RBNZ to plan for the future. We stress that **large margin of error in forecasting could result in mis-guidance of policies.** RBNZ has been pragmatic about growth and adamant in keeping monetary policy accommodative (rates low; implied preference for softer NZD) out to 2020. We reckon policymakers could end up needing to raise rate earlier than "forecasted", and the eventual market repricing of rate hikes could see NZD recover meaningfully. RBNZ Governor Orr in a recent radio interview (24 Sep) said that "challenge is to get inflation up, not down". We cautioned that RBNZ had better be careful in what they wish for! A faster than expected rise in CPI could nudge RBNZ closer to a rate hike, than they had hoped for (end-2020).

- We reiterate that NZD spot is close to testing our fair value model's lower bound of 0.66 levels (1 standard deviation of fair value estimate of 0.73 levels). Historically NZD spot has hardly traded outside of our model's lower bound and this implies that downside could be limited, barring external shocks (i.e. full-blown trade war, re-escalation of geopolitical tensions, etc.). In addition NZD net short position is near historical records. This adds to our bias that NZD downside may be limited from current levels.

- **Growth and Inflation Outlook: NZ 2Q GDP surprised to the upside** (+1% q/q vs. 0.8% expected vs. 0.5% in 1Q) as **economy expanded at its fastest pace in 2 years.** On y/y basis, growth accelerated to 2.8% in 2Q from 2.6% in 1Q. Growth was broad-based with 15 out of 16 industries recording higher production. Mining sector was the outlier; fell by most in 30 years after an unplanned shutdown disrupted gas production. Services sector led growth, in particular retail trade and accommodation, wholesale trade, and transport industries were stronger backed by a combination of increased household spending and strong international spending. While 2Q GDP silenced critics, we are cautious of 3Q growth as services and manufacturing activity (implied from PMI releases) do show a deceleration while trade deficit widened amid slump in dairy exports. Though business confidence rebounded in Sep, from 10Y lows, the level remains soft (-38.3). Taken together these forward leading indicators may suggest a deceleration in growth momentum for 3Q.

- The last MPS (9th Aug) noted that growth over the medium term is expected to recover in 2019 (towards 3.5% RBNZ projection), supported by fiscal stimulus (government's Families Package), export growth and monetary stimulus. On inflation outlook, **MPC projected a delayed return in inflation to RBNZ's target range mid-point to 1Q 2021** (from late 2020 as projected in May MPS). RBNZ expects CPI to increase in 2019, supported by non-tradables inflation while tradables inflation is expected to increase (amid fuel excise duties) but remain below its historical average.

- **Headline CPI rose to 1.5% y/y in for 2Q, up from 18-month low of 1.1% in 1Q.** The rise was due to higher prices for household energy (subcomponents including electricity, gas and solid fuels), transport (higher petrol prices), food, actual rentals and dwelling insurance. Both tradable and non-tradable inflation rose in 2Q. Headline CPI now comes close to the middle of RBNZ's inflation target range of 1 – 3%. Our internal projection also shows inflation possibly rising towards RBNZ's median target of 2% in early 2019. RBNZ quarterly survey of inflation expectation for 3Q also showed a modest rise to 2.04% y/y. Inflation expectations tend to have implication on inflation, OCR and the NZD. PPI rose further in 2Q (input up 1% vs. 0.6%; output up 0.9% vs. 0.2% q/q). This is the 9th consecutive quarters of gains amid rise in fuel prices.

- **Monetary Policy Forecast:** There is no scheduled MPC meeting in Oct. The next meeting is on 8th Nov – also the last for the year before RBNZ meets again on 13th Feb 2019. We expect RBNZ to keep the slightly dovish rhetoric unchanged and keep OCR on hold at 1.75% for the rest of the year amid cautious inflation outlook, signs of moderation in global activity, sluggish business confidence, ongoing trade war concerns between US and China as well as RBNZ's explicit guidance to pursue policy status quo. RBNZ's Orr is also likely to look past the jump in 2Q GDP as that is considered a lagged data as compared to business confidence, activity and survey indicators. Though RBNZ did caution that the next move could be a cut instead of a hike, we do not subscribe to the "cut" bias as growth, activity and inflation outlook remain promising and do not warrant a rate cut. In fact we expect inflation to pick up, owing to fiscal impulse, higher prices via import price channel given the depreciation in NZD, higher oil prices and minimum wage increases. **Our expectations is still for a rate hike in 2H 2019, much earlier than RBNZ's projection of end-2020.**

- At the last MPC meeting (27 Sep), RBNZ MPC kept OCR unchanged at 1.75% as widely expected and RBNZ continued to retain its dovish tilt. **RBNZ Governor Orr reiterated that OCR is expected to be kept at current levels through 2019 and into 2020… the direction of the next OCR move could be up or down… pledge to keep OCR at an expansionary level for a considerable period to contribute to maximizing sustainable employment, and maintaining low and stable inflation.** As expected, RBNZ acknowledged that 2Q GDP growth was stronger than anticipated but downside risks to growth outlook remain. Accompanying statement also noted that "*robust global economic growth and a lower New Zealand dollar exchange rate is expected to support demand for our exports. Global inflationary pressure is expected to rise, but remain modest. Trade tensions remain in some major economies, increasing the risk that ongoing increases in trade barriers could undermine global growth. Domestically, ongoing spending and investment, by both households and government, is expected to support growth.*

- **Latest Fiscal and External Balance Outlook:** NZ current account deficit widened to -3.3% if GDP for the year through Jun 2018 (vs. -3% in 1Q vs. -2.9% expected). This is the widest level in 3 years and this was due to increase in primary income deficit. However on seasonally adjusted terms, 2Q current account deficit was narrower than in 1Q, due to rising exports of goods and services.

- NZ government surplus is projected to be $3.1bn this year rising to $7.3bn by 2020/21. Finance Minister Grant Robertson also shared that net debt at $62.5bn is relatively low compared to international trends and at 22.1% of GDP. It is projected to fall to 20.8% of GDP for the full year and 20% of GDP over the next 5 years.

- **Key domestic events and issues to watch:** Sep house prices (3 Oct); Sep card spending (10 Oct); Sep food prices (11 Oct); Sep Mfg PMI (12 Oct); Sep services PMI (15 Oct); 3Q CPI (16 Oct); Sep net migration (19 Oct); Sep exports (25 Oct); Sep building permits, Oct business confidence and activity outlook (31 Oct).

- **Technical Outlook:** NZD rebounded from its low of 0.6501 (early Sep) to trade 0.67 levels (mid-Sep) before partially retracing gains into month end. Last seen at 0.6610 levels. Bearish momentum on monthly, weekly and daily charts remain intact though stochastics is entering oversold conditions for monthly n weekly. Further downside pressure not ruled out. Support at 0.65 levels. Decisive break below that could exacerbate more downside towards 0.6470, 0.6350 levels. Resistance at 0.67, 0.68 levels.

JPY: Bulls Could Re-Emerge

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDJPY	112.00 (--)	111.00 (--)	111.00 (--)	110.00 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** JPY has gone from hero to zero in a month. The JPY has weakened about 1.7% against the USD so far in Sep compared to the 0.8% gains in Aug. The USDJPY has largely been supported by widening yield differentials between 10Y UST and JGB bonds in Sep. Yields between the 10Y UST and JGB have widened even as the BOJ allows the 10Y JGB yield to fluctuate in a wider range than before, as the 10Y UST yield continues to hover above the 3.0% levels at the point of writing.

- Upside pressure on the USDJPY is reflected in recently released CFTC data that showed investors positioning for further weakness in the JPY in the near term. Investors have increased their short-JPY bets to 113,507 contracts as of the week of 18 Sep from 99,504 contracts in the week of 4 Sep, and also increasing their long-JPY bets to 49,752 contracts from 47,572 contracts in the week of 4 Sep. We can expect the USDJPY to remain supported for the time being. Nevertheless, given market positioning for reduced USD strength, we could see net-short JPY positions unwind and weigh on the USDJPY instead.

- In our forecast horizon, we do not expect the move higher by the USDJPY to go unabated. We are penciling in USD strength to moderate against the majors, including the JPY, going into 2019. A milder downtrend for the USD is expected towards the end of the year though we cannot rule out bouts of USD strength. We maintain our view that the USD is bound for a broad pullback as the current Fed tightening cycle is already more than half way through. A pullback in the USD should put downside pressure on the USDJPY in our forecast horizon.

- Recent data suggests that foreign flows into equities and debt have continued to reverse in Sep and further outflows could be supportive of the JPY. Previously, foreign inflows into Japanese assets had led to a concomitant dip in the JPY due to hedging activities. As we had previously noted, foreign investors hedge their Japanese asset purchases against further JPY depreciation by short-selling the JPY, thus putting downside pressure on the JPY. When foreign investors sell Japanese assets though, they unwind their short-JPY positions, putting upside pressure on the JPY. With sentiments possibly souring due to the relatively stronger JPY that could crimp corporate earnings and concerns over Sino-US trade tensions could spur further sell-offs in Japanese assets in Oct and keep the JPY supported. This should put further downside pressure on the USDJPY in the month ahead and see the pair hovering around the 112-levels by year-end.

- Note that BOJ governor Kuroda's comments on "reversal rate" theory in Nov 2017 - the BOJ's policy of keeping interest rates low were harming the profitability of commercial banks and harming their ability to lend - was interpreted by market as a signal of a tighter policy. However, the BOJ governor backtracked on those comments, suggesting that the reversal rate was unnecessary in the Japanese context as the BOJ had already made changes to its monetary framework. At the same time, market also looked at the BOJ's purchases of bonds and ETFs with every reduction seen as a sign of asset tapering. These reductions were taken as signals of "stealth tapering" by the central bank. We do not agree with this interpretation as we view such moves by the BOJ as technical adjustments, purchasing JGBs and ETFs as and when necessary to achieve its policy goals. Still, this perception of "stealth tapering" persists with 80% of economists surveyed agreeing with this description. Consequently, there could be some increase in long-JPY positioning, adding further downside pressure on the USDJPY.

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

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

- We also cannot rule out further downside risk to our USDJPY forecast should emerging market (EM) risks re-emerge. EM angst could lift the JPY higher on demand for safe-haven assets and put downside pressure on the USDJPY. Re-escalation of Sino-US trade tensions though may not spur traditional safe-haven proxy plays like the JPY. Instead, the USDJPY could climb higher as Japan itself is vulnerable to any fall-out from the trade disruption between the two world's largest economies. On the flip-side though, Japan and US are set to begin talks on automobiles and farm goods. While this should remove the threat of tariffs on Japanese goods during the talks, trade negotiations are unlike to be smooth and tension-free. Trump bluster and threat of US tariffs should trade talks falter could weigh on the JPY.

- Putting downside pressure on the JPY is the commitment of the BOJ to maintain its ultra-loose monetary policy until inflation is stable around the 2%-levels. Reinforcing this commitment was the BOJ's introduction of a forward guidance in Jul with expectations of keeping low rates "for extended period of time". This forward guidance signals that policy normalisation is unlikely within our forecast horizon and should keep the USDJPY supported, limiting the pair's downside.

- USDJPY could also come under upside pressure from the widening of yield differentials between 10Y UST and JGB. 10Y JGB yield is likely to be capped on the upside given the BOJ's preference for a measured and orderly climb in 10Y JGB yield. To guard against speculative activities, the central bank has shown its willingness to offer to buy unlimited amount of bond to temper rapid increases in the yield. As for 10Y UST yield, it is still expected to climb higher on Fed rate hike expectations and increasing supply of bonds to finance the US government's budgetary requirements.

- Thus, we expect USDJPY moves lower in the near term to be measured and maintain our USDJPY outlook for the forecast horizon. We continue to expect the USDJPY to end the year around 112. In 1H 2019, we look for the pair to hover around the 111 before easing to end-3Q around the 110-levels.

- **Growth and Inflation Outlook:** Final GDP print for 2Q 2018 showed the economy expanding at the fastest pace since 1Q 2017. Real GDP rose by +0.7% q/q sa in 2Q18, an upward revision from the preliminary print of +0.5%. Stronger personal consumption (unchanged from preliminary reading) was supportive of growth in 2Q. In addition, non-residential investment, which rose +3.1% y/y vs. +1.3% in the preliminary print, was also kept growth buoyant. Net exports were a drag on GDP in 2Q, subtracting 0.1%-pt from growth, unchanged from the preliminary reading. This final reading for 2Q18 reinforces our confidence that the economic growth momentum should persist for the rest of 2018. The government's planned extra budget of JPY1tn for disaster relief and rebuilding efforts, in addition to the FY2017 supplementary spending package of around JPY2tn, as well as preparations in the run-up to the 2020 Olympics in Tokyo should bolster economic growth for the whole of 2018 and into 2019. The

BOJ expects full-year growth to come in around 1.5% and 0.8% for FY2018 and FY2019 respectively.

- There were some glimmers of hope that inflation is on the uptick. Headline inflation rose 1.3% y/y in Aug vs. Jul's +0.9%, lifted largely by the rise in fresh food prices (Aug: +8.7% y/y vs. Jul: +4.3%). Also helping was the uptick in utilities and transport cost (Aug: +3.4% and +2.0% y/y respectively vs. Jul: +3.1% and +1.5%. Core inflation (headline less fresh food) rose by +0.9% y/y in Aug (Jul: +0.8%) on higher energy costs, while core-core inflation (headline less fresh food and energy) was up by +0.4% y/y in Aug (Jul: +0.3%). With oil prices on the uptick, inflation should remain on the grind higher, though any talk of normalisation remains premature. We expect the BOJ to continue its pursuit of its ultra-loose monetary policy until its 2% inflation target is achieved. The BOJ expects core inflation to come in at 1.1% in 2018, and then to accelerate to 1.5% and 1.6% (excluding the effects of the consumption tax hike) in FY2019 and FY2020 respectively.

- **Monetary Policy Forecast:** The BOJ unsurprisingly left its monetary policy intact at its 18-19 Sep meeting. The policy balance rate was maintained at -0.1% and the 10-year JGB yield target at around zero percent. Yield of 10Y JGB though have been on the rise as market test the upper limits of the range that the 10-year bond yield is allowed to fluctuate. BOJ operations though are likely to be used to cap too rapid climb in the yield and to maintain an orderly pace of advance in the 10Y yield. The 10Y JGB yield has hovered above the 0.10%-levels since.

- By maintaining its policy stance unchanged, the BOJ appears to signal its preference of allowing the tweaks made at its 31 Jul meeting to work its way into the financial system. At the same time, the BOJ is keeping a look-out for the side-effects of its policy on the financial and banking system, while observing the impact on inflation. The tweaks though do not represent the beginning of the end of easy monetary policy. At his post-monetary policy meeting press conference, BOJ Governor Kuroda reiterated that the current easing programme has been strengthened by the Jul tweaks and any rollback in policy is unlikely until the 2% inflation target is achieved. The push ahead with the ultra-loose monetary programme should put JPY-bears in the driver's seat and keep the JPY in the back-foot ahead.

- **Latest Fiscal and External Balance Outlook:** After fighting off a challenge to the presidency of the ruling LDP, PM Abe will submit an extra budget at the next session of Parliament, likely to take place soon. This budget to reconstruct areas that have been devastated by natural disasters such as levees damaged by deadly torrent rain in western Japan as well as the 6.7 magnitude earthquake that rocked Hokkaido on 6 Sep. In addition, the budget will also allocate funds to improve infrastructure to reduce the effects of natural disasters. The budget is expected to be worth around JPY1tn for the current fiscal year.

- The current account (CA) surplus widened to JPY2.01tn in Jul from JPY1.18tn in Jun, bolstered by the larger gains in the primary income account of JPY2.35tn (vs. +JPY0.59tn for Jun) that more than offset the deficits in both the goods & services (of -JPY0.18tn) and secondary income accounts (of -JPY0.17tn). The financial account surplus slipped into a deficit of JPY0.83tn in Jul vs. a surplus of JPY0.62tn in Jun due the large deficit of JY5.28tn in the "other investment" segment that more than offset the surpluses in the direct investment, portfolio investment, financial derivatives, and reserve assets segments. The overall balance of payments (BoP) slipped into a deficit of JPY1.66tn in Jul vs. Jun's JPY1.24tn surplus due to the large errors and omissions segment of –JPY2.83bn.

- **Key domestic events and issues to watch:** Results of the 3Q Tankan survey will be released on 1 Oct. Eyed will be BOJ Governor Kuroda's speech in Tokyo on 19 Oct. BOJ will meet on 30-31 Oct to decide on monetary policy. At the same time, BOJ will release its Outlook Report on the same day. JGB auctions in Oct: 10-year (2 Oct), 30-year (11 Oct), 5-year (16 Oct), 1-year (18 Oct) and 20-year (18 Oct).

- **Technical Outlook:** USDJPY traded higher for the month of Sep, in line with our call for bullish continuation pattern (cup and handle). We shared that move towards 113.20, 115.30 should not be ruled out. The first objective was met at time of writing. USDJPY was last 113.50 levels. Bullish momentum on weekly chart remains intact. Sustained price action above 113.20 could point to further upside. Immediate resistance at 114.60 before 115.30 levels. Support at 112 (21 DMA), 111.50 levels.

RMB: China Reacts But Not Overreact

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDCNY	6.80 (6.72)	6.70 (6.65)	6.60 (6.62)	6.60 (--)
USDCNH	6.80 (6.72)	6.70 (6.65)	6.60 (6.62)	6.60 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We see risks for USDCNY to head lower into the final quarter of the year beyond the mid-term elections. China has raised a complaint with WTO on the US trade tariff. Trump has started to accuse China of meddling in the US' mid-term elections and China has denied that. While we are less inclined to look for a resolution between the US and China in terms of trade, military or any aspect, especially with China posing an increasing threat to US technological lead, we do not expect a lot more escalation in tensions beyond the mid-term elections given the fact that the political event that has been the motivation for "China Bashing" is now over regardless of the outcome. We see potential for the USD to deflate more significantly once the mid-term elections are out of the way and as ECB prepares the market for further monetary normalization. Some convergence between the US and the rest of the DMs could see USD drifting lower and the USDCNH would take the lead from there. We look for USDCNY to head lower towards 6.80 by the end of the year, adjusted higher to take into account recent developments, divergence in monetary policy and underlying concerns that the US and China diplomatic ties could deteriorate further.

- The RMB faces downside pressure in the near-term for sure, not helped the least by the RRR cut that has been speculated for Oct. The additional 5-10% tariff that China imposed on U$60bn of US imports (some of them already subjected to tariffs before) was considered milder than expected. What was surprising was China's plans to lower average tariffs for major trading partners which could take effect in Oct. That could alleviate the price pressure at home and support consumption. The moves made by China so far seem to suggest that China would continue to react to Trump's tariffs but not overreact whilst focusing on supporting domestic demand. After all, final consumption expenditure contributed more than 77% to GDP growth in the first half of this year whilst gross capital formation contributed around 31%. The minimum threshold for personal income was lifted recently to increase the disposable income of the lowest bracket intact. Hence, further cuts in the RRR would be an additional tool to provide the credit support that the economy needs.

- In the meantime, RMB stability is paramount. The currency has depreciated 11% from its 2018 highs against the USD and around 5% against the trade-weighted basket. Further depreciation could undermine other priorities. As China's current account surpluses thin on rising services imports, the authorities strive to woo foreign institutional investors to its capital markets. MSCI had started to include A-shares in Apr and Aug this year but news broke that the index compiler could significantly increase the weight of the A-shares from next year and also including some smaller tech stocks. FTSE Russell follows suit with a decision pending on the inclusion of A-shares. This comes ahead of the Shanghai-London Stock Connect that is supposed to be launched in Dec this year. Foreign holdings of China Government Bonds have been on the rise. So we are unlikely to see a deliberate FX policy for yuan weakness as that could increase the opaqueness and uncertainty for investors. However, that does not preclude further yuan weakness against the USD should USD strengthen much more. For big trends, USDCNY and USDCNH could still take the cue from the USD. Barring a strong recession which we think is unlikely, USDCNY is likely to track the USD lower.

- **Addressing Domestic Challenges:**

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

- **Growth and inflation outlook**: Industrial production edged higher in Aug to 6.1%y/y from 6.0%. Caixin PMI-mfg for Aug softened from 50.8 to 50.6 with export sales down for the fifth consecutive month. Managers also noted rising price pressure while hiring fell. Fixed asset investment (urban) slipped further to just 5.3%y/y from previous 5.5%, underpinned by the rebound in investment in primary and secondary industry while that of tertiary industry was dragged by contractions in wholesale and retail trade and financial intermediation. Fixed asset investment in infrastructure (ytd) continues to decline from 5.7%y/y to 4.2%. Expect some stability in investment as the government had urged local government to speed up issuance of special bonds meant for financing infrastructure projects.

- Retail sales rose to 9.0%y/y last month with Jan-Aug growth averaging 9.3%. New yuan loans undershot expectations at CNY1.28trn vs. the expected CNY1.4trn. Aggregate financing surpassed expectations with a print of CNY1.52trn for Aug, supported by the stronger net corporate bond financing. Industrial profits from private companies have been on the decline for much of this year and the contraction has been accelerating.

- Inflation has crept higher in Aug to 2.3% from 2.1%, underpinned by a jump in the food subcomponent which accelerated from 0.5%y/y in Jul to 1.7% for Aug. Fresh fruits saw a rather significant acceleration in the month along with fresh vegetables and aquatic products. The meat and poultry subcomponent saw smaller decline in price pressures. The swine flu outbreak may pose as a risk to inflation expectations.

- **Monetary Policy Forecast:** Even with the series of fiscal measures, we still do not rule out another RRR cut in Oct. While retail sales (proxy for private consumption) seem to be stable, industrial profitability continues to plunge for private enterprises. The investment on infrastructure also continues to slow. RRR cut is needed for China to continue to support domestic demand, even more so as RMB stability is required and as China reacts tit for tat in the trade war.

- In the first two weeks of Sep, PBoC ramped up liquidity injections in preparation for the peak for tax payment. However, recent open market operation saw net liquidity drained for the past few sessions. The average OMO rate (weighted by outstanding securities) has also bounced in tandem, last seen at 3.24% off Sep lows of 3.21%. Deleveraging is still a priority as PBoC continues to keep average OMO rate between 3.15-3.30%. The average weighted repo rates have also edged up recently to 2.68%. 12M USDCNH forward points remain elevated above 700pips whilst that of onshore 12M forward hovered around 50pips after turning positive in Sep. The rise in forward points is a sign of depreciation expectations on the RMB and into Golden Week, we would be cautious of intervention in the offshore markets to keep USDCNH from breaching key levels.

- **Latest Fiscal and External Balance Outlook:** China had set out a target earlier this year, to reduce its budget deficit target from 3% of GDP to 2.6%, lower than speculated 2.9%. However, with the plentitude of fiscal measures undertaken recently, the budget deficit to GDP ratio could rise as China cushions growth in the face of a trade war. This is especially in light of only modest growth expected for this year.

- **Key domestic events and issues to watch:** NBS PMI and Caixin PMI due on 30th Sep; FX Reserves on the 7th; money supply, new yuan loans, aggregate financing on 10-15th; trade data on the 12th; inflation on the 16th; surveyed jobless rate, activity data including 3Q GDP on the 19th; new home prices on the 20th; FX net settlement (clients) on the 25h; industrial profits on the 27th.

- **Technical Outlook:** USDCNH hovered around 6.8820 and could remain guided by the 21-dma. Resistance at 6.91 before the year high of 6.9586. Weekly momentum points south though. So near-term, this pair could head higher but head-room seems to be limited.

KRW: A BoK Rate Hike is Likely in 4Q

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDKRW	1110 (--)	1100 (--)	1090 (--)	1080 (--)

No Change to Previous Forecasts

- **Motivation for the FX View:** We expect KRW to draw strength from potential BoK rate hike in 4Q, relative calm in RMB and possibly an upbeat risk-on sentiment on optimism that China is planning to lower import tariffs for major trading partners in Nov. In addition Korea's eligibility for "targeted relief" from steel quotas imposed by US, proposed KRW471tn fiscal stimulus (targeted to support private consumption and mitigate downside risks to growth) and improved geopolitical environment in Korean peninsula should further support the KRW. We expect a lower trading range of 1095 – 1135 for USDKRW, with bias to fade on rallies. We keep our trajectory profile unchanged for the forecast horizon.

- We still see a fairly good chance that the BoK could hike 25bps this quarter – either 18th Oct meeting or 30th Nov meeting (only 2 MPC meetings available for 2018). While headline CPI may still seem moderate at 1.5% (below BoK's 2% target), we think the actual inflation is higher than headline, due to distortion created by administered prices. We think it is important to reiterate and distinguish the difference between true inflation and headline inflation. In a separate research report by BoK, Korea's true inflation is said to rise 2.2% in 2Q, up from 1.6% in 1Q. **True inflation is defined as excluding the so-called "administered prices",** which is controlled by the government for policy purposes and it applies to 30 service items including utilities and government subsidized welfare sectors (such as medicine, education, etc.). The report said "administered prices kept a slower pace of rise compared to consumer prices, bringing down the rise of CPI". As such there is a divergence in the true CPI and the commonly referred to headline CPI (which includes those goods and services controlled by the government). To put things in perspective, true CPI rose by about 1.9% since 2016, nearing the BoK's 2% inflation target. Point to note was there was also 1 rate hike last year. And 2Q 2018 true CPI does suggest that BoK's inflation target has been met. Apart from inflation, we think some factors that may delay BoK's decision to tighten include risk of further deceleration in growth momentum given uncertainties in global arena caused by ongoing US-China trade tensions and the sluggish job market at home. On tackling the latter, we believe the planned fiscal stimulus is a more appropriate policy than monetary policy.

- Nonetheless we stress that KRW is a high beta currency and is highly sensitive to EM FX sell-off, faster pace of Fed rate hike and re-escalation of US-China trade tensions. Deterioration in one of or combination of the above event risks could subject USDKRW to abrupt spikes, overshooting our upper bound.

- **Growth and Inflation Outlook: South Korea's economic growth for 2Q was revised lower to +0.6% q/q** (vs. +0.7% preliminary estimates vs. +1% in 1Q), **owing to slower exports growth for 2Q (+0.4% vs. 4.4% in 1Q). Private consumption also saw slower pace of growth while investments** (in particular facilities and construction investments) shrunk. On y/y terms, 2Q GDP was +2.8. For 1H 2018, growth was +2.8%, missing policymakers' expectation for 2.9% for FY 2018. Though BoK had revised its forecast lower for 2018 and 2019 to 2.9% and 2.8%, from 3% and 2.9%, respectively owing to sluggish job creation, slower exports amid escalating trade war tensions between US and China, there could be risk of another growth revision next month.

- **Inflation moderated to +1.4% y/y in Aug from +1.5% y/y in Jul on declines in utilities, medical care and communication prices as well as base effects. Core CPI moderated to +0.9%** (vs. 1.1% in Aug). BoK Governor Lee had earlier said that CPI increases may be lower than earlier projection due to government's social welfare policies resulting in the reduction of utility bill for Jul-Aug (amid summer heatwave). BoK still expects inflation to rise towards 1.8% in 2Q. For the year, BoK expects inflation at 1.6%.

- **Monetary Policy Forecast**: We still see risk of a 25bps rate hike in 4Q 2018, possibly as early as at the next meeting on 18th Oct (the other possible date as well as the last BoK MPC meeting for 2018 is on 30

Nov) if demand-induced price pressures picks up pace. Minimum wage could increase by 16% this year, its largest magnitude of increase since 2001. Wage pass-through is expected to have positive impact on consumption spending, growth and lead to inflationary pressures. **BoK Governor Lee said the monetary easing needs to be reduced (early this morning) and that the BoK is monitoring the US-Korea rate gap with more caution. This could underscore policymakers' threshold of the widening differential being tested and a BoK rate hike may be imminent to prevent the widening.** To add, the **presence of a dissenter is significant for BoK policy decision.** At the 12 Jul and 31st Aug BoK MPC meetings, Lee Il-Houng, a distinguished Economist was the lone dissenter in the 7-member board.

- Recall back in 2017, he was also the lone dissenter at the Oct 2017 meeting which subsequently paved the way for the first rate hike in 6 years the following month in Nov 2017. Moreover BoK still see the economy growing at its potential rate… the growth and inflation trajectories aren't all that different from paths seen in April. In addition at the 27th Jul parliamentary session, BoK Governor Lee said that it will be necessary to adjust the level of accommodative monetary stance in an attempt to secure more policy leeway to deal with future business cycles if the economy stays on a good cycle. We believe these comments are strong hints that the BoK is preparing markets for rate hike soon.

- **BoK Governor Lee said the monetary easing needs to be reduced (27 Sep)** and that the BoK is monitoring the US-Korea rate gap with more caution. In terms of policy rate differential, Fed-BoK has widened to +75bps from +50bps and in terms of 2Y yield differentials, UST-KTB is now at +88bps (widest level on record). Further widening is yield differentials in favor of US may trigger capital outflow and result in KRW depreciation. A potential BoK rate hike could stem the differential from further widening.

- At the last MPC meeting on 31st Aug, BoK kept policy rate unchanged at 1.5%, as widely expected. Like in the last MPC meeting on 12 Jul, there was one dissenter - Lee Il-Houng, a distinguished Economist remains the lone dissenter in the 7-member board. Accompanying statement noted that economic growth is expected to be generally consistent with the path projected in Jul. BoK noted that employment conditions in Korea have become more sluggish; inflation will pick up and gradually approach the target level of 2% but may be lower than previous forecasts; uncertainties are rising in global markets more than expected due to protectionist policies; to carefully judge if necessary to adjust policy further.

- **Latest Fiscal and External Balance Outlook:** Current account surplus widened further to near 1-year high of $8.76bn in Jul (vs. $7.38bn in Jun). Goods account surplus rose sharply on the back of robust growth in semiconductor exports, services deficit improved thanks to reduced travel deficit (rise in visitors from China and Japan) and primary income surplus rose sharply on increased dividend pay-out and interest income.

- Korea's national debt is projected to reach KRW700tn this year (38.6% of GDP) and to rise to KRW740tn next year. The level remains relatively low vs. other major developed economies.

- **Key domestic events and issues to watch:** S. Korea releases Sep exports, Mfg PMI (1 Oct); Aug IP (2 Oct); Sep FX reserves (4 Oct); Sep CPI (5 Oct); Aug current account (11 Oct); Sep unemployment rate (12 Oct); BoK MPC meeting (18 Oct); Sep PPI (23 Oct); 3q prelim GDP (25 Oct); first 20 days of trade data (22 Oct); Oct consumer confidence (26 Oct); Sep IP (31 Oct).

- **Technical Outlook:** USDKRW traded a high of 1133 (11 Sep) before drifting lower below 1110 into month-end. Our call in last month's FX Monthly – to lean against strength looking for further downside play – was met. Pair was last seen at 1109 levels. Bearish momentum on weekly, daily charts remains intact though stochastics is entering oversold conditions. Immediate support at 1102 (50% fibo retracement of Jun low to Jul high) before 1094 (61.8% fibo) and 1090 (200 DMA). Resistance at 1120 (21, 50 DMAs), 1130.

SGD: Eyeing MAS Cues

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

No Change to Previous Forecast

- **Motivation for the FX View:** The USDSGD has been on quite a ride in Sep. The pair attempted to break above the 2018 high of 1.3819 but failed and instead retraced back below the 1.37-levels. We maintain our outlook for the SGD to ease further towards the 1.3650-levels by end-2018 as trade tensions is expected to ease by then once the US mid-term elections are over in Nov and USD strength moderates.

- We expect the SGD to find support from the CNY and EUR, both of which are expected to firm going into 2019. The re-introduction of the counter-cyclical adjustment factor should shield the CNY from excessive depreciation pressures. Stable CNY should anchor the AXJs including the SGD and provide room for some appreciation bias. The convergence of monetary policy between the EU and the US should be supportive of the EUR. Given the negative correlation between the EURUSD and the USDSGD, a firmer EURUSD should be put downside pressure to the USDSGD.

- Underscoring the SGD is its still healthy domestic fundamentals. The healthy budget surpluses of the past few years provide fiscal space for the government to accelerate its infrastructure programme, including development of Changi Airport Terminal 5 and the redevelopment and rejuvenation of the Jurong Lake District, should it become necessary.

Aside from the country's ample fiscal space, its triple-A status and persistent high balance of payments surpluses are also supportive of the SGD. These should provide incentive for investors to remain invested in Singapore assets, including the SGD. Taken together, the healthy macroeconomic fundamentals should keep the SGD supported and keep the USDSGD on its gradual downward trajectory going into 2019.

- There are some in the market that is positioning for another move by the MAS to further normalise policy. These market participants believe that inflationary pressures are picking up given that oil prices have remained elevated above the USD80/bbl-levels on supply constraints. Higher energy prices could thus have a knock-on effect on consumer prices in Singapore and lift core inflation beyond the 2% levels. Though a further policy normalisation move by MAS is not our base case, we acknowledge that the risks of such a possibility have risen. Consequently, we could see some positioning for SGD strength in Oct, putting downside pressure on the USDSGD.

- Unlike the Aug-Sep, which tends to be seasonally weak months for the SGD vs. the USD, Oct could provide the USDSGD with some downside relief. This is because Oct tends to be a seasonally stronger month for the SGD vs. the USD. In six out of the past 10 years, the SGD has shown relative strength against the USD in the month. We could thus see the USDSGD slip lower from current levels towards the 1.3650-levels by end-3Q.

- Still from now to the mid-term elections, we cannot rule out bouts of USD strength from further moves by the Fed to tighten policy as well as improving data that highlights resiliency of the US economy. At the same time, the threat of trade disruption from escalating trade tensions between China and US could keep the USD supported. For the SGD this is a double-whammy as the USDSGD could remain supported and trade could take a hit as Singapore is acutely reliant on trade.

- Trade disruption is coming at a time when there are signs that the synchronised export-led recovery is waning. The electronic cycle appears to be losing steam and could be nearing its end. Thus, the slowdown in the global supply-chain could be exacerbated and weigh on the Singapore economy. This in turn should drag the SGD lower. Should the trade disputes escalate into a trade war, there could be further downside risks to our SGD outlook.

- In the absence of fresh directional catalyst, we maintain our outlook for the USDSGD in the next 4 quarters amid a moderate reduction in USD strength. We continue to expect the USDSGD to end-2018 around the 1.3650-levels. Thereafter, we expect the USDSGD to be on a slow grind lower towards the 1.36-levels by end-3Q 2019.

- **Growth and Inflation Outlook:** Softer economic growth is likely to persist into 1H 2018. Already, IP has decelerated in the two months of Jul and Aug, averaging 5.0% y/y compared to 10.7% in 2Q. Fading electronics cycle and supply chain disruptions from Sino-US trade war is likely to weigh on manufacturing. At the same time, recent harsh property measures should dampen demand for property-related business services and construction outlook. Consequently, our economic is projecting slower growth of 2.6% y/y in 3Q18 (vs. 2Q's +3.9%). For the full-year, our economic team maintains its real GDP growth forecast at +3.5% for 2018. It also kept its 2019 growth forecast at +2.7% for 2019. MTI maintains its GDP forecast at 2.5-3.5% for 2018.

- Headline inflation edged slightly higher to 0.7% y/y in Aug to a 17-month high compared to 0.6% in Jul, underpinned by softer accommodation costs (Aug–2.6% y/y vs. Jul: -3.0%) Private road transport cost though continued to fall by -0.2% y/y in Aug (Jul: -0.3%) as car price increases were muted. Core inflation (excludes private road transport and accommodation costs from headline inflation) came in at +1.9% y/y in Aug, unchanged from Jul. Elevated core inflation could be attributed to higher retail and food inflation that offset a moderation in services inflation. Food inflation rose 0.7% y/y in Aug (Jul: +0.6%) on the back of non-cooked food items and prepared meals, while retail prices edged up by 2.0% y/y vs. Jul's +1.6%. Services inflation softened to 1.3% y/y in Aug from +1.5% in Jul due to the drop in communication services fees.

- The outlook for inflation remains broadly subdued. Lower private road transport cost (on muted COE premiums) should weigh on headline inflation. Sino-US trade war though increases downside risks to inflation and growth. Note also that a trade war is deflationary and could contain inflationary pressures for the rest of 2018 and into 2019. However risks to core inflation have risen. Rising oil prices above the USD80/bbl level could keep utilities fees and public transport cost elevated ahead. For now though, our economic team maintains its current headline and core inflation at +0.7% and +1.7% respectively for 2018. MAS continues to look for core inflation to rise gradually for the rest of 2018, averaging at the upper half of its 1-2% forecast range for 2018. It projects headline inflation to be within the upper half of its 0-1% forecast range for 2018.

- **Monetary Policy Forecast**: After pursuing an accommodative policy the past two-and-a-half years, the MAS began the process of policy normalisation at its semi-annual policy meeting on 13 Apr. MAS shifted to a 'slight appreciation bias' for the SGD NEER by increasing slightly the slope of the policy band at the 13 Apr meeting. Other policy parameters, namely the level at which the band is centred and the width of the policy band, were left unchanged. Underpinning this move was MAS' expectations that core inflation will be on the slow grind higher on improving labour market and on moderate rise in oil and food commodity prices amid the steady expansion path of the economy. In the absence of information from the MAS, we have assumed the slope of the SGD NEER policy band to be at the stronger end of the 0-1% range at 0.75% p.a. This should allow for a stronger SGD on a trade-weighted basis to mitigate the expected climb in core inflation in both 2018 and 2019.

- Crude oil prices as represented by Brent have been on the uptick, surpassing the USD80/bbl-mark. There are some expectations in the market for crude oil prices to return to the USD100/bbl levels but this is not our base case. We think that more moderate global growth and likely OPEC moves to ensure ample supply should cap crude oil prices ahead. Still, we acknowledge that risks to a possible MAS move have risen as a result of elevated oil prices. MAS though may still not move on tighten policy further as uncertainty over global trade remains. Escalation in global trade tensions could weigh on both economic growth and inflation and mitigate the need for MAS to tighten for the time being. Our house view remains for the MAS to maintain its current 'slight appreciation bias' at its policy meeting expected sometime in the second week of Oct, with but with the probability of tightening slightly higher now for the Oct round.

- The USDSGD has attempted to test but has failed to breached the 2018 high at 1.3819 (15 Aug) but has since come off amid USD de-escalation of Sino-US trade tensions. Pair had slipped to a recent low of 1.3612 (21 Sep) but has bounced off that low to hover around the 1.3650-levels at the point of writing. Softer USDSGD though has not translated into slower increases in domestic interest rates. The 3-month SOR (3MSOR) has accelerated from the 1.66% levels at the start of Sep to around 1.71%-levels at the point of writing. The 3MSOR though is fast approaching the 2018 high of 1.73% (seen on 10 May and a level not seen since 13 Jan 2016). Meanwhile, 3-month SIBOR (3MSIBOR) made a new 10-year high of .6413% on 21 Sep has been hovering at that level since. Both the 3-month SOR and 3-month SIBOR remain elevated as the withdrawal of monetary stimulus in the advanced economies continues. We are now gradually seeing mortgage rates respond to the climb in domestic rates. Deposit rates (for 12-month fixed) also continues to edge higher, climbing 2bp to 0.40%-levels on 3 Sep. This suggests that risks related to interest rate increases affecting financial and economic stability, particularly in interest rate- and property-related sectors, remain on the gradual uptick.

- USD 3MLIBOR has come off slightly after climbing to a new 2018 high not seen since 2008 at 2.381% on 25 Sep. Fed balance sheet reduction is playing a part in draining liquidity from the system and this has resulted in the recent moves higher in domestic rates vis-à-vis the USD 3MLIBOR. We expect the 3MSIBOR and 3MSOR to edge higher to 2.08% and 1.96% respectively by end-4Q 2018. For 1Q 2019, we are penciling the 3MSIBOR and 3MSOR to come in at 2.03% and 1.91% respectively.

- **Latest Fiscal and External Balance Outlook:** Tax revenue collected by the government picked up slightly in Jul after slowing in May. Tax revenue collected in Jul was at SGD5.7bn compared to SGD5.5bn. This slightly improved tax revenue collected was due to the pick-up in corporate income tax collected of SGD1.9bn vs. SGD1.8bn in Jun, as well as the SGD1.0bn (vs. -SGD0.34bn in Jul) collected under "other taxes".

- The current account (CA) surplus widened to SGD22.83bn in 2Q 2018 compared to SGD20.5bn in 1Q. As a percentage of GDP, the CA surplus rose to 20% in 2Q vs. 18.4% in 1Q. The wider CA surplus was largely attributable to the increase in the goods and services surplus of SGD29.38bn in 2Q vs. 1Q's SGD27.66bn. The financial and capital deficit narrowed to SGD14.10bn in 2Q from SGD15.32bn in 1Q due to the larger direct investment inflows of SGD13.70bn (1Q: +SGD8.5bn) and smaller outflows of SGD18.41bn (1Q: -SGD26.62bn) from the "other investment" segment. Consequently, the overall balance of payments (BoP) surplus widened to SGD7.8bn in 2Q vs. SGD6.8bn in 1Q.

- **Key domestic events and issues to watch:** Key data releases eyed in Oct include MAS bi-annual policy meeting expected sometime 8-12 Oct. Released simultaneously will be advanced estimates for 3Q GDP.

- **Technical Outlook:** USDSGD was last seen at 1.3670 levels. Near term technical suggests upside risk. But bearish momentum on weekly chart remains intact. Pair may still trade range-bound for the month. Support at 1.36 (38.2% fibo retracement of 2017 high to 2018 low). Resistance at 1.3710 (21 DMA), 1.3780 (50% fibo).

MYR: Declining Carry Allure

Forecast	4Q 2018	1Q 2018	2Q 2019	3Q 2019
USDMYR	4.1200 (4.0700)	4.1000 (4.0500)	4.0800 (4.0500)	4.0800 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View: Motivation for the FX View:** In line with most other regional currencies, the MYR weakened against the USD by around 0.9% in the month of Sep. It reached a high of 4.1505 on 12 Sep 2018, due largely to external uncertainties from the escalation of trade war and its concomitant CNY weakness as well as some loss from MYR carry relative to other regional FX as markets in part also price in some domestic risk premium on MYR assets. The MYR also did not seem to strengthen despite Brent crude oil price moving beyond $80/bbl. At the same time, crude palm oil production and prices seem to be falling as well the past year, potentially contributing to the MYR.

- The risk of a possible global trade war becoming more sustained, coupled with continuing Fed policy normalisation and repatriation of corporate earnings, may further add to USD tightness. In that base scenario, riskier and commodity currencies are likely to remain vulnerable. Further out, we continue to anticipate more USD underperformance on the back of a further flattening of the UST yield curve, concerns about the deteriorating US twin deficits and long USD positioning becoming a bit overstretched.

- In addition, our economics team sees rising likelihood that the BNM could keep rates on hold until 2019 to support domestic demand especially consumer spending. This is happening in an environment where regional central banks are tightening more to keep pace with the hikes in US policy. Taking all these into consideration, we revise higher again our USDMYR forecasts for this year to incorporate market developments and the factors above.

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

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

- We reiterate our **long-standing bias that the Ringgit remains fundamentally undervalued.** Our fair value estimate (which takes into account interest rate differential, inflation differential, current account differential and reflation variables) puts USDMYR at 3.70 levels. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals (which remain intact). We believe stability is gradually returning to Ringgit as political/ contingent liability risk subsides, fiscal consolidation gains traction, oil prices continue to stabilize and uncertainty subsides. Solid underlying fundamentals and policies, backed by domestic demand, re-calibrated supportive budget (on a lower oil price assumption suggests flexibility in the fiscal space), relative stability in oil prices though some downside pressure exists, relative attractive yields in the MGS, stabilizing FX reserves to retained imports & short-term debt, accommodative monetary conditions (to support businesses) remain intact and should provide an anchor for MYR stability once short-term noises subside. **We still believe USDMYR range of 3.80-3.90 is likely to remain relatively sustained in the medium term as policy certainty sets in.** Based on BIS data, MYR REER is about 5-6% undervalued relative to its 10-year average. We had previously said that Ringgit weakness was temporary and was not a reflection of underlying fundamentals. We believe stability is gradually returning to Ringgit as political/contingent liability risk subsides, fiscal consolidation gains traction (budget deficit expected to be cut further to -2.8% of GDP vs. 3% of GDP in 2017), oil prices continue to stabilize and uncertainty subsides.

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

- External reserves fell by -USD0.5b in first half of Sept 2018 to USD103.9b (end-Aug 2018: USD104.4b) amid continued net foreign selling of Malaysian equities so far this month. The latest external reserves figure is adequate at 8.1 months of retained imports, 0.9 times of total short-term external debt (mostly belonging to banks with significant asset covers) and 112% of IMF's Assessing Reserves Adequacy (ARA) metric.

- Foreigners are –MYR0.6b net sellers of Malaysian equities so far in Sept 2018 (Aug 2018: -MYR0.1b). Latest data on foreign flows in the Malaysian bond market showed –MYR2.4b net sell in Aug 2018 (July 2018: +MYR4.0b) and our Fixed Income (FI) Research team expects further net selling in Sep 2018 in view of the MGS yields' movements this month as the 3-Year yield rose to 3.61% as at 21 Sept 2018 from 3.48% at end-Aug 2018 and the 10-Year yield moved up to a high of 4.16% on 6 Sept 2018 from 4.03% at end-Aug 2018 before easing to 4.08% as of 21 Sept 2018. At the same time, there is the potential maturity-related selling (instead of re-investment) by foreign investors as MYR12.7b worth of MGS expires on 28 Sep 2018.

- Downside risks to external reserves from portfolio capital flows in limited in our view. Year to date foreign net sell of –MYR9.3b Malaysian equities have reversed 88% of the +MYR10.6b net buy last year, while the cumulative foreign net sell of –MYR22.7b Malaysian bonds since Apr 2018 has reversed 69% of the +MYR32.8b net buy in the preceding 12 months.

- **Growth and Inflation Outlook:** Our economics team expects economic growth to moderate to 5.1% this year (2017: 5.9%), mainly reflecting the impact of the measures and policies of the new Pakatan Harapan (PH) Government announced so far. The zero-rating of GST between June-Aug 2018 and its abolition in Sep 2018 as well as the fuel price stabilisation programme until end-2018 are expected to boost consumer spending growth. However, the impact of these measures on Government revenues and spending amid the commitment to achieve the Budget 2018's deficit target of -2.8% of GDP will result in prudent Government spending. Meanwhile, review of major infrastructure projects could pose some risk to investment outlook. Our full-year growth forecast implies moderation in quarterly growth in 2Q-4Q 2018 after the 5.4% expansion in 1Q 2018. At this juncture, we expect +5.3% growth in 2Q 2018 before growth decelerate further to around 4.8%-5.0% in 2H 2018. Index of leading economic indicators fell -0.7% YoY in May 2018 (Apr 2018: +1.4% YoY). Growth-wise, the index has been on a soft patch since Dec 2017. Given that the index growth leads GDP growth by 2-3 months, it signals further slowing in real GDP growth in 2Q 2018 and 3Q 2018 after the deceleration in 4Q 2017 and 1Q 2018.

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

- BNM sounds more cautious on growth. Global growth momentum is showing signs of slowing amid downside risks to domestic growth from trade tensions, prolonged weakness in the mining and agriculture sectors, impact on public sector spending as Government embarks on reprioritisation of expenditure, as well some domestic policy uncertainty.

- Unofficially, the official growth forecast for 2018 have been lowered to "around 5%" from 5.5%-6.0% previously. The downward revision will be confirmed when Budget 2019 is tabled on 2 Nov 2018.

- Meanwhile, BNM is less dovish in inflation now as it expects inflation to edge upwards going forward and into 2019 as the effect of 0% GST is transitory and lapses toward end-2019. In previous MPS, inflation was expected to turn negative in some months and remain low in 1H 2019 before trending upwards. To note, inflation rate was sub-1% YoY in June 2018 (+0.8% YoY) and July 2018 (+0.9% YoY) reflecting the consumption tax holiday impact in June-Aug 2018.

- As expected, headline inflation stayed south of 1.0% YoY in Aug 2018 on slow increases or declines in the prices of goods and services, reflecting the impact of "consumption tax holiday" following the zero-rating of GST during the Jun-Aug 2018 period. Core CPI dropped further by -0.2% YoY in Aug 2018, the same as in Jul 2018.

- Both headline and core inflation rates in Jan-Aug 2018 were subdued at +1.3% YoY and +1.1% YoY respectively. Given the year-to-date inflation rate; the end of "consumption tax holiday" with the implementation of Sales Tax and Services Tax (SST) on 1 Sep 2018; the increase in minimum wage to MYR1,050 per month next year; as well as the confirmation that the Government is going to change current "blanket" fuel subsidy to a targeted and quota-based system next year, we raised our 2018 and 2019 headline inflation rate forecasts to 1.0%-1.5% (previous: 0.5%-1.0%) and 2.0-2.5% (previous: 1.5%-2.0%) respectively.

- The initial impact of SST implementation on headline inflation is expected to be modest as businesses may partially absorb the tax, as exemplified by the cigarette price increase of between 1% to 4% despite the imposition of 10% Sales Tax.

- Despite the above upward adjustments in headline inflation forecasts for 2018 and 2019, they remain moderate relative to the +3.7% inflation rate in 2017. In addition to moderate inflation rate, domestic economic growth is expected to be softer. We expect real GDP growth of +4.8% in both 2018 and 2019 (2017: +5.9%), and BNM last month indicated that it expects this year's real GDP growth to be around +5.0% vs its Mar 2018's projection of between +5.5% and +6.0%.

- **Monetary Policy Forecast:** BNM kept the OPR unchanged at its Monetary Policy Committee (MPC) meeting on 4-5 Sep 2018 i.e. no change in OPR for the fourth successive MPC meeting. BNM kept the Overnight Policy Rate (OPR) at 3.25% after its Monetary Policy Committee (MPC) meeting on 4-5 Sep 2018, unchanged for the fourth straight meeting. Maintain our view of no change in OPR until end-2019.

- The accompanying Monetary Policy Statement (MPS) was "less dovish" on inflation as it expects inflation to edge upwards going forward and into 2019 as the transitory effect of 0% GST period in June-Aug 2018 lapses. In the preceding MPS, BNM had expected inflation rate to turn negative in some month and remain low in 1H 2019 before trending upwards.

- The economic growth and inflation outlook supports our view of no change in BNM's current Overnight Policy Rate (OPR) level of 3.25% until end-2019 after the +25bps hike at the Monetary Policy Committee (MPC) meeting on 25 Jan 2018.

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

- Furthermore, post-GFC, BNM's monetary policy objective also includes financial stability. Under current environment of US-led rising global interest rates and volatility in Emerging Market's capital and FX markets, interest rate policy plays a role in managing capital flows and currencies, further underlining our view of no change in OPR.

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

- Our Economists estimated that GST removal entails a revenue loss of MYR44bn (based on Budget 2018 projection). **Replacing GST with the previous Sales and Services Tax (SST) which last earned a full-year revenue of MYR17b in 2014, there is a prospective net tax revenue loss of MYR27b.** Malaysia's budget deficit to GDP ratio will arithmetically increase by as much as 1.9 percentage points, just on this basis alone, assuming no offsetting reduction in expenditures or revenues from oil or more efficient collection of taxes. However this is only a simplistic assumption for preliminary illustration.

- On oil prices, our Economists shared that every US$10/bbl increase in annual average crude oil prices will boost government revenues by MYR7-8bn via oil related revenues. Last year's average crude oil price averaged US$54/bbl, up from US$44/bbl in 2016. And YTD 2018, crude oil price averaged about US$69. Theoretically the US$15 increase in crude prices from 2017 works out to a potential increase in government revenues by MYR10.5bn – 12bn.
- Potentially higher government revenues from increase in oil prices could partially buffer against revenue losses from removal of GST and re-instatement of fuel subsidy.
- We had previously shared that brent could be poised for further upside, with next objective seen at $82 (61.8% fibo retracement of 2014 peak to 2016 trough). Support levels seen at $71.50, $61 levels. Upside risks to oil prices suggest room for positive surprise as government budget assumption (Budget 2018) for oil prices was conservative at $52/bbl.
- **Key domestic events and issues to watch:** Trade data (5 Oct); FX reserves (5 & 22 Oct); Industrial Production (11 Oct); CPI (24 Oct), BNM Policy Meeting (8 Nov).
- **Technical Outlook:** USDMYR continued to trade higher for the month of Sep. Last seen at 4.14 levels. Bullish momentum on weekly chart remains intact but shows signs of waning while stochastics is in overbought conditions. Uptrend still intact but gains could slow given stretched technical conditions. Near term, we do not rule out retracement risks. Support at 4.13 (21 DMA). Decisive break below this could see further downside pressure in play towards 4.10 levels. Resistance at 4.15, 4.1780 (50% fibo retracement of 2017 high to 2018 double-bottom low).

IDR: Buoyed By Credible Policy Mix

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDIDR	14600 (--)	14500 (--)	14300 (--)	14200 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** The USDIDR remains among the worst performing currency in Asia, edging close to the psychological 15000-levels. The USDIDR climbed to touch a high of 14940 on 5 Sep – a level not seen since Jul 1998 during the Asian Financial Crisis. This move higher comes amid the re-escalation of trade tensions, higher crude oil prices at above USD80/bbl, and rising global yields with UST yields above the 3.0% levels. Nevertheless, we do not expect the pace of IDR depreciation to match the 10.3% climb in the USDIDR year-to-date. A move beyond the psychological 15000-levels cannot be ruled out in the near term though, especially as market discerns the impact of further Fed rate hikes, but we expect such moves to be short-lived.

- Our expectations of a pullback in the USDIDR in the forecast horizon are premised on several factors. First, the measures implemented by both BI and the government including intervention in the FX and IndoGB (so far using more than USD14bn its foreign exchange reserves), tariffs to curb imports to reduce conspicuous consumption, delay in some infrastructure projects to reduce imports, should help to curb excesses in the current account, while introduction of more hedging products, including interest-rate swaps, should stabilize the IDR. In the works are plans to offer incentives to encourage exporters to convert their foreign-denominated earnings into IDR. According to BI, less than 15% of exporter earnings are converted into IDR in 1H 2018. Greater conversion into the IDR could help provide the IDR with a buffer and some stabilisation.

- **The introduction of a domestic non-deliverable IDR forwards (DNDF) by BI at its Sep policy meeting should provide another avenue for market participants to hedge their foreign currency exposure. The instrument should be effective sometime in Oct. Currently, onshore players are not allowed to quote offshore NDFs though offshore NDFs are used quite blatantly still. The aim of the DNDF is to shift demand for hedging onshore and to further deepen the domestic financial system. Some features of the proposed are (1) banks are prohibited to carry out domestic NDF transactions against the MYR and THB given existing swap agreements between the three economies; (2) there must be underlying transactions such as trade in goods and services, investments or bank loans among others; (3) the amount and period of a DNDF transactions must not exceed the amount and period of the underlying transaction; and (4) contract settlement is in IDR based on the BI's spot USD rate - the JISDOR. For now, there is little is little details as to the framework or how it will DNDF will be operationalize. But for the DNDF to be effective alternative hedging instrument, the authorities may have to enforce a complete ban on domestic financial institutions quoting the offshore NDF for clients.**

- Second, just as importantly, is that the ongoing monetary policy tightening cycle still has legs. To date, the BI has hiked its policy rate by 150bp since May to anchor the IDR. The commitment of BI to remain preemptive and front-loaded in terms of monetary policy should amplify the credibility of the central bank, helping to provide support to the IDR. The prospects of further rate hikes should help flush out speculators and bring some semblance of calm back to the IDR.

- Third, twin deficit aside, economic fundamentals in Indonesia are still relatively healthy. Inflation remains muted and growth remains steady if not lackluster. At the same time, the government still has fiscal space to support the economy. Spending ahead of the presidential and general elections in 2019 as well as preparation for the World Bank-IMF Annual Meetings in Bali on 12-14 Oct should be positive not only for economic growth but for the IDR as well. Fourth and finally, expectations of a moderation in USD strength could also put downside pressure on the USDIDR in the forecast horizon. With the Fed more than half way through its tightening cycle, further support for the USD might not be forthcoming. Moderation in USD strength could anchor the AXJs including the IDR and allow room for some downside moves by the USDIDR.

- So far in Sep, foreign investors have on the whole sold off equities and debt, putting upside pressure on the USDIDR. Nevertheless, yields of government bonds 10Y and beyond at 8% and above are relatively attractive in the Asian EM space. Similarly, the sell-off in equities to date should make Indonesian equities attractive again. Year-to-date, foreign investors have sold USD3.75bn but purchased USD0.41bn in debt. So far in the week of 21 Sep, there has been renewed interest in Indonesian assets with foreign funds purchasing USD0.07bn and USD0.34bn of equities and debt. Further net foreign portfolio inflows should weigh on the USDIDR in the months ahead.

- Going into 2019, we can expect some volatility in the markets as the 17 Apr Presidential and general elections draw closer. For now, the opinion polls point to strong support for Jokowi but things can change from now till Apr next year. Signs of waning support for Jokowi could shake market confidence and sent the USDIDR even higher. Our house view is for a Jokowi to win at this juncture, which should put downside pressure on the USDIDR going into the elections.

- While there could be near-term upside pressure on the USDIDR, we do not expect this to persist. Follow-through by both BI and the government with credible policies should inspire confidence in investors and return calm to the IDR. Seen in this light, we maintain our forecast for the USDIDR to come in around 14600-levels by end-2018 helped by the government measures to curb the current account deficit and shore up foreign reserves. In 2019, we look for the pair to edge slightly lower to towards the 14200 by end-3Q 2019.

- **Growth and Inflation Outlook:** Real GDP growth for the rest of the year is likely to be lackluster. Government efforts to curb IDR weakness and contain the current account deficit are likely to impact growth negatively, particularly the measure to hold back some import-heavy infrastructure projects and to curb imports of luxury consumer goods. These though do imply that government support for growth has waned. We believe that government spending remains supportive growth, including spending ahead of the presidential and general elections in Apr 2019 and major events like the World Bank-IMF Annual Meetings in Bali (12-14 Oct). While higher interest rates are likely to dampen private spending to some extent, macroprudential measures, especially for home buyers, could mitigate some of this risk. This should allow the economy to expand by 5.13-5.25% in 3Q and 5.1-5.23% in 4Q respectively. This should bring full-year economic growth to 5.14-5.21% for 2018, though the government sees downside risks to its 5.3% forecast for 2019 on account of the measures to curb the current account deficit. Our economic team though continues to expect the economy to expand by 5.21% in 2018 before accelerating to 5.31% in 2019.

- Headline inflation was little changed in Aug at 3.20% y/y compared to 3.18% in Jul. Higher transport and housing costs of 1.8% and 2.12% y/y respectively in Aug was offset by the dip in food prices (Aug: +4.90% y/y vs. Jul: +5.35%). Higher crude oil prices and weaker IDR though could lift domestic production cost and feed into consumer prices. Core inflation was also mildly higher in Aug rising 2.90% y/y compared to 2.87% in Jul. The government's move to curb imports and the current account deficit should also help the issue of imported inflation. The 7.5% tariff on around 900 consumer goods should reduce demand for imported goods and put downside pressure on inflationary pressures. Consequently, our economic team expects headline and core inflation to average 3.36% and 2.86% for 2018 respectively. The BI continues to target inflation to come in within 2.5 and 4.5% in 2018.

- **Monetary Policy Forecast:** As expected, BI hiked its 7-day reverse repurchase rate again by 25bp to 5.75% at its 26-27 Sep meeting amid ongoing volatility in the IDR. This marks the fifth rate hike by the central bank this year and brings the cumulative moves to 150bps so far this year. The deposit and lending facility rates were lifted by 25bp as well to 5.00% and 6. 05% respectively, keeping the interest rate corridor at 75bp on either side of the policy rate. This move by the BI remains consistent with the governor's strategy of keeping policy "pre-emptive, front loading, and ahead of the curve" in order to maintain macroeconomic and financial system stability.

- With 150bp rate hike in its pocket, this could be an opportunity for the BI to pause and observe the impact of its previous rate hikes on the domestic economy and the IDR. In its policy statement, the BI noted that the depreciation in the IDR "is in line with the currencies of peer countries, spurred by broad US dollar appreciation". This suggests that the BI could be less pressured to move again on its policy rate for now. The central bank is likely to sit tight and make its next move at its Dec policy meeting with another 25bp rate hike to 6.00%.

- **Latest Fiscal and External Balance Outlook:** Parliamentary budget committee has given its approval to President Jokowi's 2019 state budget estimates. Estimates for growth target of 5.3%, inflation target range of 2.5-4.5%, exchange rate of 14400 per USD and 3-month treasury yield of 5.3% were approved. The government intends to narrow the 2019 budget deficit to 1.84% of GDP from 2.12% targeted this year as the government stepped up efforts to boost confidence as the currency and asset markets fell. The key budget assumptions for 2019 include GDP growth of 5.3%, inflation of 2.5-4.5%, crude oil price at USD70/bbl and average USDIDR at 14,400.

- The current account deficit (CAD) could widen further in 3Q 2018. CAD had already widened to USD8.03bn in 2Q 2018 (equivalent to 3.04% of GDP) from USD5.54bn (2.21% of GDP) in 1Q. This expected widening in CAD in 3Q is attributable to the ballooning trade deficit in Jul and Aug, which totaled USD3.0bn, vs. 1Q's deficit of USD1.37bn. Holding all things equal, this could mean that 3Q current account deficit could stay elevated around the 3.0% levels. This could make it difficult for the BI to keep the current account deficit below 3% of GDP by end-2018.

- Nevertheless our economic teams remain sanguine that this target is achievable. The measures announced by the government on 14 Aug to shore up its foreign exchange reserves could go some way to temper the CAD. The measures include plans to curb capital and consumer goods imports by imposing a tax of 7.5% on select products, moves to accelerate the use of biodiesel fuel to cut the import of oil, the push for import substitution whenever possible, and to promote tourism. Consequently, our economic team now projects a current account deficit of around 2.70% of GDP in 2018 vs. 2.50% of GDP previously.

- **Key domestic events and issues to watch**: In focus in Oct will be BI's policy meeting on 22-23 Oct. Also keenly eyed will be foreign reserves for Sep for clues as to how much reserves have been drawn down to defend the IDR.

- **Technical Outlook:** USDIDR traded higher for the 4th consecutive month in a row. Last seen at 14,900 levels. Bullish momentum on weekly chart remains intact but shows signs of waning while stochastics is in overbought conditions. Bulls may feel lethargic and we do not rule out retracement risks. Support at 14800, 14550. Resistance at 15000.

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDPHP	53.50 (--)	54.00 (--)	53.90 (--)	53.70 (--)

No Change to Previous Forecast

- **Motivation for the FX View:** The initial lackluster response from the BSP to inflationary pressures saw the USDPHP punished, making it one of the worst performing currencies in the region since the start of the year. The lack of central bank credibility for being behind the curve saw the USDPHP pushed to a multi-year high of 54.459 on 25 Sep. The two back-to-back 50bp rate hikes by the BSP served to restore the credibility of the central bank and also removed the perception that the central bank was lagging in its response to inflationary pressures. The cumulative rate hike of 150bp to bring the policy rate to 4.50% since May and hints that the central bank will do all that is necessary to rein in prices have since allayed market concerns about central bank creditability. This commitment by the central bank to use all the tools in its arsenal to rein in inflation should weigh on the USDPHP and allow the pair to slip lower below the 54-handle by year-end, as long as the long USD pressure eases.

- USDPHP should continue to come under upside pressure from the ongoing sell-off in Philippine equities by foreign investors. Foreign investors have so far sold USD212.1mn in equities in Sep on concerns over inflation (including the negative impact from the devastation wrought by Typhoon Mangkhut), a still hawkish BSP and simmering trade war concerns. Foreign investors have sold off USD1.6bn in equities year-to-date. But this negativity in the equity market can reverse. Our analysis using the Cyclical Adjusted P/E (CAPE) ratio model though continues to suggest that domestic equities appears relatively cheap (as reflected by the estimated P/E ratios minus their 10-year average P/E ratios) compared to its regional peers. This is particularly given the expected strong economic performance this year. Greater inflows towards the end of the year and into 2019 once the current risk aversion episode fades should weigh on the USDPHP and allow the pair to ease from the 54-levels in 3Q to around the 53.50-levels by end-2018.

- Aggressive downside moves in the USDPHP though could be limited in the near term given that economic fundamentals remain soft. The trade balance remains in a deficit, still hovering above the USD3bn mark still. At the same time, overseas remittances has rebounded from its decline of 4.5% in Jun to +5.2% in Jul, though year-to-date overseas remittances has averaged +4.4% lower than the +5.2% for the whole of 2017. In addition, the current account deficit should have widened to over 3.0% of GDP even more on elevated oil prices (in value terms) given that Philippines is an oil-importing economy. The government's ambitious infrastructure building programme is likely to keep the current account in deficit in 2018 and possibly into 2019 as well. Further deterioration in the current account deficit should be supportive of the USDPHP.

- **Further USDPHP downside may not persist in the early part of 2019. This is because general elections will take place on 13 May 2019 with 12 seats in the Senate and all seats in the House of Representatives as well as all regional, provincial, city and municipal positions will be up for grabs**. Should the opposition win a majority of the seats in both Houses of Congress, they could effectively block the parliamentary agenda of President Duterte who would be mid-way through his one-term in office. The uncertainty in the lead-up to the elections could force investors to sit on the side-lines until clarity in the political environment emerges. Until then, we could see the USDPHP come under stress in the lead-up to the elections with the pair possibly climbing back towards the 54-handle by end-1Q 2019 before easing off as political clarity emerges.

- With further rate hikes in the works, moderation in USD strength expected and trade tensions fade, USDPHP should remain under pressure towards end-2018 with the pair ending 2018 at 53.50. Rising political risk as elections for the House of Representative and half of the Senate approach should lift the USDPHP higher back towards 54.00 by end-1Q 2019. Thereafter, the more moderate reduction in USD strength together with the return of political certainty should see the USDPHP ease to 53.90 and 53.70 by end-2Q and end-3Q respectively.

- **Growth and Inflation Outlook:** Economic growth slowed to 6.0% y/y in 2Q from a downwardly revised 6.6% in 1Q (previously 6.8%). The moderation in growth was due to the worsening net external demand though domestic demand growth momentum was sustained. Except for construction, the slowdown in the economy was relatively broad-based. Growth in the manufacturing and services sectors eased to 5.6% and 6.6% respectively in 2Q from 7.6% and 6.8% in 1Q. The mining sector shrank while the agriculture sector stagnated. Bucking the trend was construction that expanded 13.5% y/y in 2Q on the back of a pick-up in private construction which accounted for almost 60% of total construction, as well as sustained momentum in public construction. With 1H growth coming in at 6.3% y/y, the economy is expanding at a pace below the 6.5% average for the past five-years. In view of the 1H 2018 performance and the BSP's 150bp rate hikes YTD, our economic team has revised lower its 2018 and 2019 growth forecasts to 6.3% and 6.5% respectively (previously 6.8% for both years).

- Headline inflation rate (base year = 2012) posted its highest rate since Mar 2009 (of +6.6%) in Aug, accelerating by +6.4% y/y compared to +5.7% in Jul as the Tax Reform for Acceleration and Inclusion (TRAIN) Act measures continues to impact consumer prices, together with a weaker PHP and higher costs of food & non-alcoholic beverages (FNAB), utility and transport. Core inflation (CPI excluding selected food items as well as energy prices) also picked up, rising by 4.8% y/y in Aug from 4.5% in Jul. Given elevated inflation so far in 2018, the BSP has revised upwards its 2018 and 2019 inflation forecast to +5.2% and +4.3% respectively from +4.9% and +3.7% previously. Its 2020 projection was left unchanged at +3.2%. Our economic team has similarly lifted its 2018 and 2019 inflation outlook to +5.5% and +4.8% respectively from +5.1% and +3.9% previously on account of the negative impact from Typhoon Mangkhut and upside risks to crude oil prices.

- **Monetary Policy Forecast:** The BSP has followed up its 50bp move in Aug with another similar 50bp hike to its overnight borrowing rate. This brought the benchmark rate to 4.50bp. This move marks the most aggressive tightening by the BSP since 2000. The BSP left the interest rate corridor intact with the overnight lending rate and overnight deposit rate both raised by 50bp accordingly to 5.00% and 4.00% respectively. The interest rate corridor remained symmetrical on either side of the policy rate by 50bp. The pressure to be more aggressive on rates was because of "persistent signs of sustained and broadening price pressures" as inflation has outpaced the upper bound of the central bank's target range of 2-4% for this year and next.

- Like the previous 50bp rate hike, the current move does not signal the end of the tightening cycle. The upgrade in inflation forecast for 2018 and 2019 to 5.2% and 4.3% respectively from 4.9% and 3.7% previously suggests the BSP is open to further policy tightening to anchor inflationary expectations. Market is already suggesting the need for another 50bp hike towards the end of the year to keep inflationary pressures in check. With the BSP suggesting that the growth momentum is sustainable despite the rate hikes, and its commitment to use all the tools in its toolkit to rein in inflation, further rate hikes by the BSP cannot be ruled out this year. Our economic team is looking for another 100bp rate hike within the next six months with 50bp likely to come by the end of 2018.

- **Latest Fiscal and External Balance Outlook:** The fiscal deficit narrowed significantly in Jun to just PHP2.6bn vs. Jul's deficit of PHP86.4bn in Jul. This can be attributed to the sharp drop in government expenditure in Aug of PHP259.5bn vs. PHP328.1bn in Jul. Revenue collected in Aug rose to PHP256.9bn from PHP241.7bn in Jun. YTD. The fiscal deficit for the first eight months of the year rose to PHP282bn.

- The current account deficit ballooned in 2Q 2018 to USD2.93bn (or equivalent to 3.56% of GDP) compared to a deficit of USD0.16bn (or equivalent to 0.2% of GDP) in 1Q. It is likely that the current account deficit for the whole of 2018 will overshoot the BSP's projection of a deficit of USD3.1bn (-0.9% of GDP) for 2018. The wider deficit was primarily driven by the deficit in the goods and services account which ballooned to USD10.1bn in 2Q from 1Q's –USD7.38bn. The capital and financial account rebounded to a surplus of USD0.76bn in 2Q from a USD0.51bn deficit in 1Q, helped by a stronger direct investment of USD3.05bn, though this was partially offset by the deficit in the portfolio investment, financial derivatives and other investment sub-accounts of USD2.29bn (1Q: -USD1.54bn). Consequently, the overall balance of payment deficit ballooned to USD2.03bn vs. 1Q's USD1.23bn deficit. The central bank continues to project a BoP deficit of USD1.5bn (-0.4% of GDP) for the whole of 2018 even though this level has already been breached.

- **Key domestic events and issues to watch:** There is no central bank meeting in Oct but focus will be on CPI for Sep on 5 Oct to clues as to whether inflation has peaked. In addition, market will eye foreign reserves for Sep to see how much reserves have been run down to defend the PHP.

- **Technical Outlook:** USDPHP traded higher for the month of Sep. Last seen at 54.11 levels. Bullish momentum on weekly shows signs of waning. Rising wedge pattern appears to be in the making. This is typically associated with a bearish reversal. Decline could re-visit 53.33 (23.6% fibo retracement of 2017 low to 2018 high), 52.64 (38.2% fibo). Resistance at 54.50.

THB: Political Risks Emerging

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDTHB	32.80 (33.50)	33.00 (33.80)	32.60 (33.60)	32.60 (--)

Previous Forecasts in Parenthesis

- **Motivation for the FX View:** The THB continues to be the best performing Asian currency in Sep with the THB gaining 0.7% against the USD, while year-to-date it has risen by 2.80%. The stars appear aligned in favour of the THB. Healthy economic fundamentals including healthy growth momentum, return of foreign interest in Thai debt, the increasing expectations of policy normalisation by the BoT as well as being a beneficiary of the possible shift of manufacturing away from China is weighing on the pair. We have revised our USDTHB outlook lower over the forecast horizon to reflect these positive risks to the THB.

- Unlike Indonesia or the Philippines, macro-economic fundamentals remain relatively healthy in Thailand and continue to underpin the USDTHB. Persistent current account surpluses (around 9% of GDP in 2Q) remain supportive of the THB. In addition, we are looking for a pick-up in private investment to drive the next phase of growth and the THB higher. Our optimism arises from the high correlation between private investment and trade for Thailand. At the same time, the trade spate between China and US could see manufacturing activities shift away from China towards ASEAN, in particular into Thailand. Meanwhile, the government's push to accelerate infrastructure projects, especially the USD47bn Eastern Economic Corridor project ahead of general elections expected in Feb 2019 could also deliver upside surprises to domestic demand, growth and weigh on the USDTHB.

- The angst over EM risks and Sino-US trade tensions has largely dissipated. At the same time, with the Fed nearing the end of its policy tightening cycle, risk assets are again back in favour. The THB is a beneficiary of this asset rebalancing, particularly given its robust growth momentum. This asset rebalancing has spurred renewed foreign interest in Thai debt with foreign investors purchasing USD1.27bn in debt so far in Sep. Year-to-date, a total of USD6.90bn of debt has been purchased. Further foreign inflows into debt in the quarter ahead should weigh on the USDTHB.

- In contrast, equities continue to be sold off with foreign funds selling USD0.27bn in the month-to-date in Sep, while year-to-date, they had sold a total of USD6.56bn in equities. This sell-off has been largely due to ongoing profit-taking activities after strong foreign inflows of USD2.24bn for the whole of 2016 are likely to persist. These profit-taking activities reflect investors' belief that the economy is facing domestic structural headwinds, including hollowing out of industries, ageing demographics and rising leverage. We do not think that these structural issues can be resolved overnight and these concerns will thus continue to weigh on Thai equities. At the same time, there could be some re-allocation of assets away from Thailand in 4Q as political uncertainty re-emerges in the run-up to the general elections expected early 2019. We could thus see limited downside to the USDTHB ahead.

- Still, we do not expect further aggressive moves lower in the USDTHB in 4Q. This is because while 3Q tends to be a seasonally strong quarter for the THB vs. the USD as corporates repatriate funds for the fiscal year-end, 4Q is typically a weak quarter for the THB. At the same time, the re-emergence of political risk as the general elections approaches should put upside pressure on the USDTHB in 4Q 2018 and 1Q 2019.

- A key driver of THB strength so far has been the rising expectations that the BoT will normalise monetary policy by the end of the year. Strong economic fundamentals suggest less need for an extremely accommodative monetary policy. However, an aggressive pace of normalisation is unlikely given the need to keep growth support and to curb excessive THB strength. Policy normalisation sooner rather than later would provide the BoT with policy space to response to any external shocks. Growth accelerating back towards potential with a concomitant pick-up in inflation highlights the case for a rate hike. Our economic team is penciling in a rate adjustment sometime at the BoT's Nov or Dec policy meetings.

- Political risk could re-emerge in the coming months and weigh on the THB. The organic laws related to the election of MPs and appointment of Senators have been endorsed by HM King Vajiralongkorn and the ban on political activities have been partially lifted to allow for the parties to organize and elect their party leaders. It is beginning to look very likely that the general elections will take place in 24 Feb 2019. So far the moves towards the general elections have been supportive of risk sentiments and weigh on the USDTHB. However as we noted previously, the political temperature could rise as election fever catches towards the end of the year and into 2019. This should keep investors on the sidelines until political uncertainty dissipates. Such political concerns are likely to put upside pressure on the USDTHB in the next six months.

- Our base scenario is for the general elections to proceed as planned on 24 Feb 2019. We believe that a majority government by a single party is unlikely given the new Constitution. A fractious parliament made up of smaller parties is likely with the Senate dominated by 250 members appointed by the military junta. This should allow the military to retain influence in the government as no single party will be able to command a majority. More likely than not, PM Prayuth should remain as PM as a result. We do not expect any change in economic policy direction and for the BoT to begin policy normalisation in 4Q 2018. Some initial volatility is expected in the aftermath of the election but we expect the THB to stabilise and continue on its appreciation path thereafter.

- Given the positive risks to the THB, we have tweaked our USDTHB outlook for the forecast horizon but maintain its trajectory. We now expect the USDTHB end 2018 and end-1Q 2019 at 32.80 and 33.00 respectively on election risks (33.50 and 33.80 previously) before easing to 32.60 (from 33.60 previously) in both 2Q and 3Q 2019 as political tensions ease.

- **Growth and Inflation Outlook:** Growth momentum is unlikely to let up in Thailand. Though the economy had moderated slightly in 2Q to +4.6% vs. 1Q's pace of +4.9% we believe the economic recovery has legs. Government spending, especially ahead of the general elections expected early next year, together with planned infrastructure building projects including transport networks and the Eastern Economic Corridor development project should attract FDI and continue to bolster growth. We continue to expect the export-led recovery to spark a revival in private investment that should sustain growth in 2018, given the high correlation between export recoveries and machinery & equipment investments for Thailand. Even a rate hike of 25bp at the end of the year is unlikely to derail growth momentum as monetary policy should still remain accommodative. Our economic team is penciling full-year growth of 4.5% for 2018, while BoT is expecting real GDP growth to come in at 4.4%.

- Headline inflation accelerated in Aug by 1.62% y/y from 1.46% in Jul. The main culprit for driving consumer prices higher was again higher food prices (Aug: +0.77% vs. Jul: +0.02% y/y). Energy cost moderated in Aug with transport cost rising by a more moderate +3.86% y/y vs. Jul's +4.4%. Core inflation (headline inflation excl. raw food and energy) was largely unchanged at +0.75% y/y in Aug compared to +0.79% in Jul. The BoT continues to project headline and core inflation of 1.1% and 0.7% for 2018. Our economic team is still penciling in inflation to average 1.3% in 2018.

- **Monetary Policy Forecast:** The BoT maintained the status quo in monetary policy, keeping the policy rate unchanged at 1.50% since Jun 2015. The last time the policy rate was even lower was during the Great Financial Crisis in 2009 at 1.25%. There does not seem to be any sense of urgency in the BoT to normalise policy, in contrast to its ASEAN peers who have already begun the process of policy normalisation. This is because the BoT has the policy space to be patient given its persistent current account surplus (9.8% of GDP in 2Q 2018) and strong foreign exchange reserves of USD205bn.

- Nevertheless, the accommodative bias of the central bank nearing its end-point with the BoT Governor Veerathai Santiprabhob expounding on 20 Aug that "there was less need for an extremely accommodative stance since the recovery in the economy is clearer" as saying. Though he has walked back on those hawkish comments following the spike in the THB, there are some expectations that the BoT could normalise monetary policy as soon as year-end to provide it with policy space to ease should the external environment deteriorates. The case for a rate hike could though emerge as growth accelerates back towards potential that could result in a concomitant pick-up in inflation. Accordingly, our economic team continues to look for the

BoT to normalise sooner rather than later and a 25bp rate adjustment is expected to take place either at its Nov or Dec policy meetings.

- **Latest Fiscal and External Balance Outlook:** The Finance Ministry expects the budget deficit to narrow as a percentage of GDP by 2020 as the targeted budget gap is expected to remain around THB450bn even as the economy expands. Implementation of strict fiscal discipline should contain the budget shortfall in 2020. The government expects the budget deficit starting in 1 Oct 2019 to average 2.6% of GDP.

- After ballooning in Jun, the current account surplus has narrowed in Jul. The current account surplus came in at USD1.09bn in Jul compared to USD4.08bn in Jun. This moderation was largely due to the smaller trade surplus of USD0.86bn in Jul (Jun: +USD2.88bn) and a drop in the surplus in the primary and secondary income segments to just USD0.23bn in Jul (Jun: +USD1.21bn). Nevertheless, the overall balance of payments recorded a smaller deficit of USD0.90bn in Jul vs. USD5.29bn in Jun. Details for the financial account are lacking at the point of writing but continued portfolio outflows are likely to remain the main culprit for the deterioration in the overall BoP in Jul.

- **Key domestic events and issues to watch:** Though no central bank meeting is scheduled for Oct, market will be closely watching CPI print for Sep on 1 Oct for any acceleration in inflation.

- **Technical Outlook:** USDTHB drifted lower in Sep; consistent with our technical call to lean against strength. Pair was last seen at 32.385 levels. Bearish momentum on weekly chart remains intact. Bias remains to sell on rally. But near term risks skewed to the upside. Resistance 32.60, 33 levels. Support at 32.20 (200 DMA), 31.80 levels.

INR: Slowing The Current Account Deterioration

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDINR	73.50 (69.00)	74.50 (68.50)	74.00 (68.20)	73.50 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** USDINR remained buoyed near the 73-figure, amid rising brent price (which broke above the U$80/bbl). As long as the outlook for crude oil price remains bullish, it is hard for the rupee to turn the corner. Current account deficit widened from U$13bn to U$15.8bn, albeit better than the expected U$17.3bn. Unsurprisingly, a significant contribution to the deficit came from the worsening trade deficit of goods within which the oil import bill had swelled. In a bid to slow this vicious circle, the government just announced (26 Sep) to impose tax on U$12mn of goods. 19 items will attract higher import levy including air-conditioners, refrigerators, washing machines, articles of jewelry, footwear, cut & polished colored gems) and this levy is meant to lower imports of these goods by 1.5-4%. FDI rose rather substantially from around U$6.4bn to U$9.7bn but that was offset by the fall in portfolio investment. Support from RBI for the rupee is not substantial. FX reserves steadied in Sep, last seen around U$40bn. Equity market saw a significant sell-off recently when the shadow lender Infrastructure Leasing & Financial Services Ltd defaulted on its debt payment on 21st Sep. This prompted Finance Minister Jaitley to assure investors that the government will provide ample liquidity to mutual funds and non-bank financial companies. Concerns of NBFC's ability to cope with rising yields could limit the room for RBI to raise policy rates next week.

- Fortunately, Aug CPI eased more than expected to 3.69%/y from previous 4.17% with significant deceleration in food inflation and slowdown in the housing subcomponent that offsets the rise in the fuel and light subcomponent. That should allow some room for RBI to pause after the hike on 5 Oct. Normal rainfall levels or rather manageable deficits (relative to 50y average) could continue to support harvest and tame food inflation. Higher base effects could also dampen headlines into the next few months, allowing CPI to remain under the 4%. That should buy RBI and the government some time to work on non-performing loans in banks and in NBFC. However, that would not be able to stem further weakness in the rupee as brent continues to rise.

- **Growth and Inflation Outlook:** Industrial production slowed to 6.6%y/y in Jul from 7.0%y/y. While non-durable goods have plunged, consumer durable goods surged in recent months along with primary goods. So activity seems to have picked up unevenly in the past few months. PMI-mfg came in softer at 51.7 vs. the previous 52.3 with softer expansions of output and new orders reported by purchasing managers. RBI forecast of order books also came off a bit more for 3Q and that could suggest a limit in how much output will accelerate. In the meantime, lower rupee and rising energy prices could buoy price pressures and dampen the purchasing power of households.

- Aug CPI slipped towards 3.69%/y from previous 4.17% dampened by slower food inflation and smaller rises in housing subcomponent that offsets the acceleration in the fuel and light subcomponent. Normal rainfall levels or rather manageable deficits (relative to 50y average) could continue to support harvest and tame food inflation. Higher base effects could also dampen headlines into the next few months, allowing CPI to remain under the 4%.

- Trade deficit steadied at around U$17.4bn in Aug, rather close to May 2013 record highs as imports growth continued to outstrip that of exports growth. With the US still waging a trade war with China that started in Jul, net exports could become a bigger drag on the headline for 3Q growth. In addition, India has

- **Monetary Policy Forecast:** The next MPC meeting is on 5th Oct and expectations are for RBI to hike. Failure to do so could result in further rupee weakness. There has been an increasing disparity in opinions on growth conditions amongst the MPC members stated in the Minutes of the Aug meeting. Dholakia takes the decline in capacity utilization as a sign of widening output gap while some others expect closing of the output gap to increase inflationary pressure. We do not think the next hike would come as easy as the ones so far. Our view is that RBI is unlikely to raise cost of financing for the sake of defending the rupee as that could risk dampening consumption and investment. This is especially so in light of recent development that saw the default of debt payments by Infrastructure Leasing & Financial Services Ltd that triggered concerns that other non-bank financial companies could have similar challenges coping with rising yields. In addition, current data and latest RBI industrial survey suggests manufacturing growth and industrial activity are already subdued and could remain so in the next few months.

- Still, managing inflation is still the mandate of the RBI and recent inflation prints have softened. That should take the pressure off the central bank to raise rates further after this one. In fact, for the next few months, favourable base effects could temper the CPI headline and allow RBI and the government some time to work on the non-performing loans. The weakening rupee has a part to play for import inflation that could threaten headlines and fx reserves suggest that the support for the currency seems to have lessened in Sep.

- **Latest Fiscal and External Balance Outlook:** With the price of brent crude still rather elevated, current account is still at risk of further deterioration. Finance Minister announced that the fiscal deficit for FY17 is poised to come in at 3.5%, well above the 3.2% projected as tax collections following the implementation of GST was lower than expected. The RBI also released a report on the states budget, reporting that the consolidated gross fiscal deficit overshot the budget estimates in 2017-18 due to shortfalls in own tax revenues and higher revenue expenditure. For the coming year, the government estimates fiscal deficit to improve to 3.3%.

- **Key domestic events and issues to watch:** PMI-mfg on 1st Oct; RBI meets on 5th; Sep CPI and Aug IP on 12th; trade and WPI on 15th.

- **Technical outlook:** 1M NDF remains rather biased to the upside, last seen around 72.94. Momentum is increasingly bullish for this pair. Next key level is 75. Support at 71.84.

VND: Eyes Still On the RMB

Forecast	4Q 2018	1Q 2019	2Q 2019	3Q 2019
USDVND	23300 (23000)	23200 (22900)	23100 (22800)	23100 (--)

Previous Forecast in Parenthesis

- **Motivation for the FX View:** We remain optimistic that the dong could strengthen towards 23100 next year from the current levels at around 23300 vs. the USD. We see some likelihood that the USD has reached an interim peak and further unwinding of long USD positions could take the USD lower against the RMB as well as the VND.

- The RMB is primarily affected by the China-trade war. Despite the fact that this could be all about protecting the US intellectual property rights and its lead in technology, a lot of “China bashing” is also likely meant to be for Trump’s domestic audience ahead of mid-term elections. Beyond 6 Nov, the political motivation is past and the next political event (US Presidential Election) is two years away. We do not think that trade war could still dominate much of the headlines beyond the US mid-term elections and less talk on it could simply see RMB appreciate in a more benign USD environment.

- The amount of FDI came off rather sharply in Aug and Sep, down 42-48%y/y for the past two months. The decline coincides with the start of the trade-war and underscores the fact the decline in risk appetite amongst foreign investors with the trade war in the backdrop. At home, the Planning and Investment Minister said that the government will add measures to boost private investment. Regulations that have been impeding business investment will be tweaked. Constructions will also be accelerated at infrastructure projects to ensure its competitiveness relative to regional peers.

- For a country that is so reliant on trade and exposed to China and the US, the ongoing trade war between the US and China remains a downside risk for the VND. That explains the outflow seen in the equity markets. However, the outflow seems to have slowed from U$111mn to –U$4.5mn. USDVND could remain a tad biased to the upside but could find some relief thereafter should trade tensions subside along with the US mid-term elections and we look for a mild retracement towards 23100 towards the end of the year.

- **Growth and Inflation Outlook:** Exports accelerated to 15.4%y/y in the first 9 months from previous 14.5% in the first 8 months. While imports remained rather steady at 11.8%y/y vs. the previous at 11.6%. As a result, trade surplus widened to U$700mn. CPI came in steady at 3.98%y/y, narrowing missing the consensus at 4.0% while GDP for the first 3Q softened to 6.98%y/y from previous 7.08%. Retail sales steadied at 11.3%.

- With price pressure still benign, we see less need for a rate hike. The government could continue to use policies and administration to keep prices in check. The legislature targets a cap of 4% for CPI and ADP recently revised its forecast for Vietnam’s inflation higher to 4%, citing inflationary pressures that stem from the weakening VND, rise in international oil and food prices.

- **Monetary Policy Forecast:** We hold the view that SBV is unlikely to move policy rates. As other central banks in the region hiked rates to buffer against further currency weakness that threatens their inflation outlook, there seem to be some speculation that SBV could do the same. However, the recent inflation data for Vietnam suggest that price pressures are still in control and are unlikely to dampen consumption. As such, SBV should be less motivated to hike rates. Furthermore, FDI has slowed since Jul this year. With a trade war still on between the US and China, we do not think it is a favourable environment to raise cost of financing for businesses. As such, we hold our view that policy rates are unlikely to change for the rest of the year.

- In terms of NEER, VND has appreciated a tad from where it was end Aug. This was probably due to the depreciation in the heavily weighted RMB that was not matched by the VND. In terms of NEER, VND has gained significant competitiveness compared to its trading partners from a year ago and that could buffer Vietnam's exports in a trade war environment.

- **Latest Fiscal and External Balance Outlook:** The Ministry of Planning and Investment forecasts 2018 state budget deficit at VND204trn, equivalent to 3.67% of GDP. 2019 budget deficit is expected to improve to 3.6% of GDP. Vietnam's fiscal position is likely to remain in consolidation mode as fiscal deficit ratio remains above the 3%-level. The government needs to fund state budget deficit of VND 206.15trn and pay principal loans of CNY157.13trn this year. The government aims to reduce budget deficit to 3.5% of GDP by 2020.

- Current account surplus narrowed to U$1.24bn in 3Q from the previous U$4.3bn. Net trade surplus of goods slipped to U$3.0bn from previous U$5.2bn. The competitive dong could keep the current account in surplus. Financial account surplus narrowed to U$2.295bn. Overall balance of payments records a surplus and could support the VND.

- **Key Domestic Events and Issues to Watch:** PMI Mfg on the 3rd; domestic vehicle sales in 6th-13th; CPI, trade numbers, retail sales, IP and 3Q GDP are due 25th-30th Sep.

FX Forecasts

	End Q4-18	End Q1-19	End Q2-19	End Q3-19
USD/JPY	112	111	111	110
EUR/USD	1.1800	1.1900	1.2000	1.2200
GBP/USD	1.3200	1.3000	1.3400	1.3500
AUD/USD	0.7100	0.6900	0.6800	0.7000
NZD/USD	0.6500	0.6700	0.7000	0.7200
USD/SGD	1.3650	1.3650	1.3600	1.3600
USD/MYR	4.12	4.10	4.08	4.08
USD/IDR	14600	14500	14300	14200
USD/THB	32.80	33.00	32.60	32.60
USD/PHP	53.50	54.00	53.90	53.70
USD/CNY	6.80	6.70	6.60	6.60
USD/HKD	7.85	7.80	7.80	7.80
USD/TWD	30.60	30.50	30.40	30.20
USD/KRW	1110	1100	1090	1080
USD/INR	73.50	74.50	74.00	73.50
USD/VND	23200	23100	23100	23000
DXY Index	94.15	93.52	92.69	91.57
SGD Crosses	End Q4-18	End Q1-19	End Q2-19	End Q3-19
SGD/MYR	3.0183	3.0037	3.0000	3.0000
SGD/IDR	10696	10623	10515	10441
SGD/THB	23.81	24.03	23.97	23.90
SGD/PHP	39.19	39.56	39.63	39.49
SGD/CNY	4.98	4.91	4.85	4.85
SGD/HKD	5.75	5.71	5.74	5.74
SGD/TWD	22.42	22.34	22.35	22.21
SGD/KRW	813	806	801	794
SGD/INR	53.85	54.58	54.41	54.04
MYR Crosses	End Q4-18	End Q1-19	End Q2-19	End Q3-19
EUR/MYR	4.86	4.88	4.90	4.98
JPY/MYR	3.68	3.69	3.68	3.71
MYR/HKD	1.91	1.90	1.91	1.91
MYR/CNY	1.65	1.63	1.62	1.62
GBP/MYR	5.44	5.33	5.47	5.51
AUD/MYR	2.93	2.83	2.77	2.86
NZD/MYR	2.68	2.75	2.86	2.94
MYR/IDR	3544	3537	3505	3480
MYR/INR	17.84	18.17	18.14	18.01
MYR/KRW	269.42	268.29	267.16	264.71
MYR/PHP	12.99	13.17	13.21	13.16
CNY/MYR	0.6059	0.6119	0.6182	0.6182

Source: Maybank FX Research as of 28 September 2018

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

DISCLAIMER

Published by:

Malayan Banking Berhad
(Incorporated in Malaysia)

Saktiandi Supaat	Christopher Wong	Fiona Lim	Leslie Tang
Head, FX Research	Senior FX Strategist	Senior FX Strategist	Senior FX Strategist
saktiandi@maybank.com.sg	wongkl@maybank.com.sg	Fionalim@maybank.com.sg	leslietang@maybank.com.sg
(+65) 63201379	(+65) 63201347	(+65) 63201374	(+65) 63201378