

FX Insight

(Re-send) SGD - Time To Normalise Policy

Economic Growth And Inflation Are Poised To Accelerate

The global and domestic economic backdrop is improving. Economic growth continues to be driven by the synchronized recovery in exports in the region for the past few quarters. The economic recovery has allowed the output gap to be mildly negative for most of 2018 before closing by end-2018 as suggested by our estimates. This is reflective of the ongoing cyclical recovery. The milder output gap together with the economic recovery could put upside pressure on inflation in 2018. This upside pressure on inflation could be exacerbated by rising global oil prices. With core inflation climbing towards the upper bound and potentially exceeding the MAS' forecast of 1-2%, normalising policy with a shift to a slight appreciation bias could mitigate any aggressive acceleration in consumer prices that could re-emerge in 2018.

Taylor Rule Estimates Suggest Strengthening SGD NEER

Our estimates for the SGD NEER using the Taylor Rule show that the SGD NEER is expected to strengthen ahead. SGD NEER is expected end 2017 at around 126.86 and then climb steadily to end 2018 around 128.43. The implied USDSGD forecasts correspond to the estimates ranging from 1.3415 - 1.3580. Based on our analysis, normalizing policy by shifting to a 'slight appreciation bias' would be more appropriate. Extending the neutral policy could exacerbate the upside pressure on inflation. This analysis reinforces our view that MAS is likely to normalize policy at its Oct meeting.

Shift To Slight Appreciation Bias Positive For SGD

MAS will release its monetary policy statement on 13 Oct. The balance of risks appears to be biased towards inflation and maintaining the neutral policy for periods longer than necessary could exacerbate inflationary pressures. We therefore look for the MAS to normalise policy with a shift to a "slight appreciation bias" in Oct. Tightening by MAS should be positive for the SGD, especially given that market is underpricing an adjustment by MAS. We maintain our forecast for the USDSGD to come in around the 1.35-levels by end-2017, before climbing higher to 1.3550 and 1.3650 levels by end-1Q and -2Q 2018 and then to hover around the 1.37-levels in both 3Q and 4Q 2018. Unlike its peers in the region, the shift in policy to a slight tightening bias would make the MAS the leader of the pack. ASEAN central banks remain on an easing bias or neutral policy for now, given growth concerns. Against this backdrop of regional monetary policy divergence, SGD gains could still persist against other regional currencies but we see more pronounced strength against the INR and the JPY. We look for opportunities to long the SGD against short-INR and -JPY towards first objectives at 48.40 levels and 84.00 levels and then at next objectives at 49.00 and 85.00 respectively.

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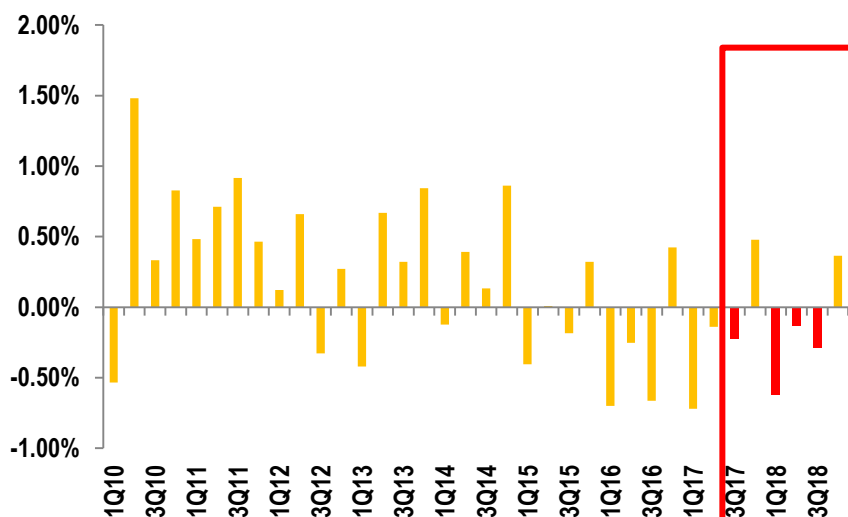
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Economic Recovery Intact And Accelerating, Closing the Output Gap

The global and domestic economic backdrop is improving. Economic growth continues to be driven by the synchronized recovery in exports in the region for the past few quarters. Our economic team is expecting the economy to rebound by 3.0% in 2017 and then expand at a steadier pace of 2.4% in 2018, driven still by manufacturing and broadening to include services. This economic recovery is expected to allow the output gap to be mildly negative for most of 2018 before closing by end-2018 as suggested by our estimates (Chart 1). This is reflective of the ongoing cyclical recovery.

With the gap likely to dissipate in 2018, there is little need for the MAS to continue with its neutral policy. Growth is also humming along with potential downside growth risks easing, a delay in normalising policy could see the MAS playing catch-up and tighten even more aggressively. Thus, the Oct meeting could be an opportune time for the MAS to normalise its policy and shift to a “slight appreciation bias”.

Chart 1: Maybank Estimates Suggest Output Gap Is Only Mildly Negative



Source: CEIC, Maybank FX Research & Strategy

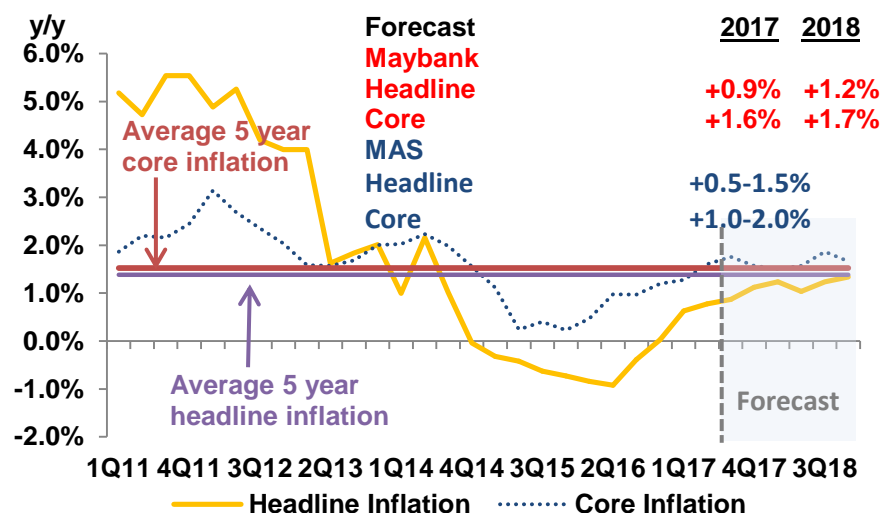
Core Inflation Could Exceed Expectations

The milder output gap together with the economic recovery could put upside pressure on inflation in 2018. This upside pressure on inflation could be exacerbated by rising global oil prices. Already Brent crude oil - the benchmark for oil price in Asia - has been on the uptick since the middle of the year and is currently hovering around the USD56/bbl levels. Risk to our inflation outlook though is subdued wage growth due to the remaining slack in the labour market that could make domestic consumers resistant to pass-through of higher costs.

Our economic team continues to expect headline and core inflation to average 0.9% and 1.6% in 2017. The team expects consumer prices to tick higher in 2018 with headline and core inflation averaging 1.2% and 1.7% respectively. Core inflation could start to climb above its 5-year average

of 1.5% in 2H 2018 (Chart 2). MAS is forecasting headline inflation to average 0.5-1.5%, while projecting core inflation to rise 1-2%. With core inflation climbing towards the upper bound of and potentially exceeding the MAS' forecast, normalizing policy with a shift to a slight appreciation bias could mitigate any aggressive acceleration in consumer prices that could re-emerge in 2018.

Chart 2: Core Inflation Could Climb Above Its 5-Year Average in 2018



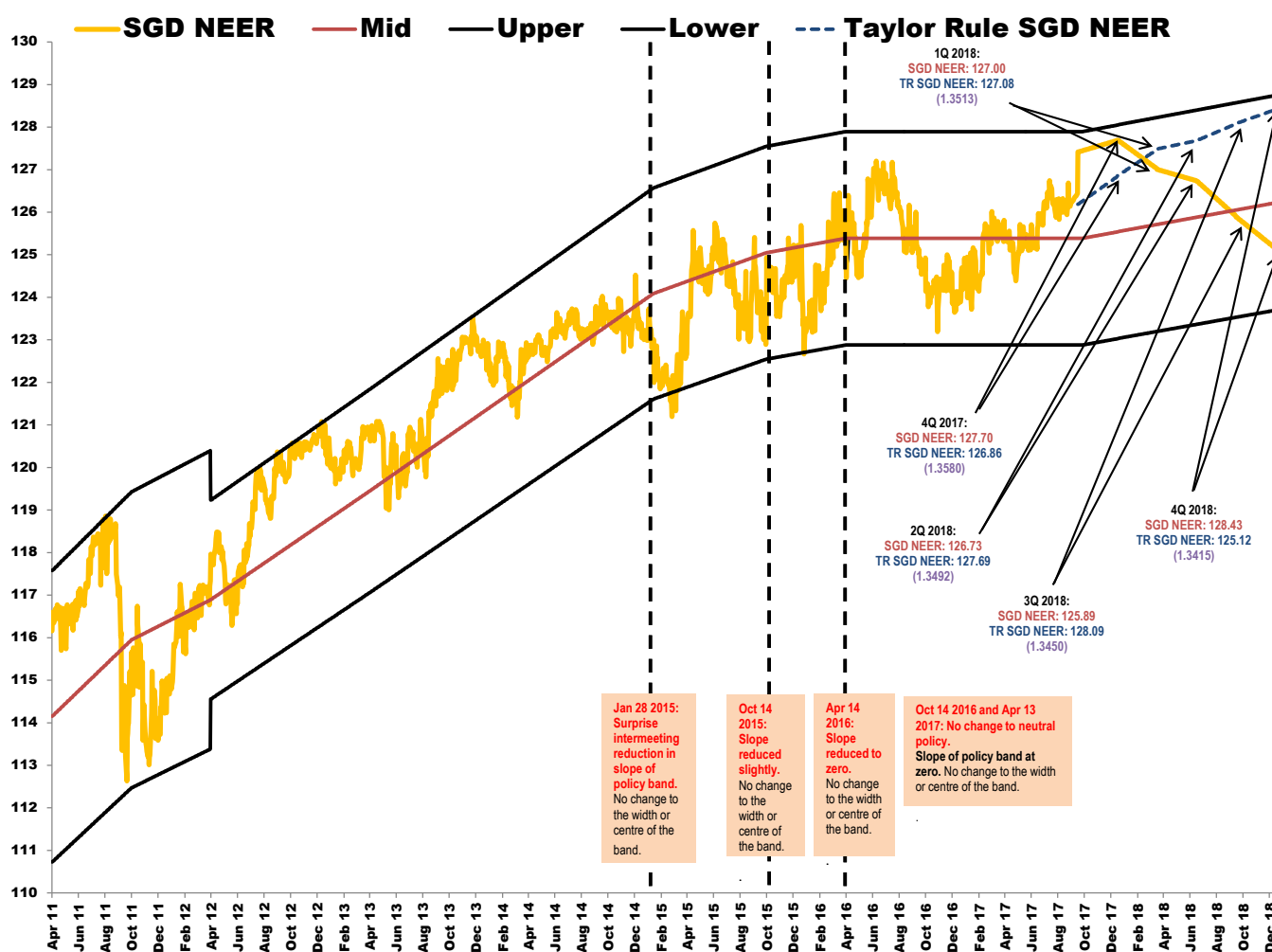
Source: CEIC, Maybank MKE, Maybank FX Research & Strategy

Taylor Rule Estimates (Growth and Inflation Trade-Offs) Suggests SGD NEER To Strengthen Ahead

Our estimates for the SGD NEER using the Taylor Rule show that the SGD NEER is expected to strengthen ahead (Chart 4). SGD NEER is expected end 2017 around 126.86 before ticking higher to 127.49, 127.69 and 128.09 in 1Q, 2Q and 3Q 2018 respectively. The SGD NEER is estimated to end 2018 around 128.43. The implied USDSGD forecasts corresponding to these estimates are 1.3580 (4Q 2017), 1.3513 (1Q 2018), 1.34917 (2Q 2018), 1.3450 (3Q 2018) and 1.3415 (4Q 2018).

Based on our analysis, normalizing policy by shifting to a 'slight appreciation bias' would be more appropriate. Extending the neutral policy could exacerbate the upside pressure on inflation. This analysis reinforces our view that MAS is likely to normalize policy at its Oct meeting.

Chart 3: Taylor Rule - SGD NEER Estimates*



*Estimated using GMM Model using an augmented Taylor Rule Framework

Source: Bloomberg, Maybank FX Research & Strategy

Normalising MAS Policy Sooner Rather Than Later

Since 2000, there have only been two episodes where the MAS had shifted to a neutral policy. The shift to a neutral policy in those two episodes was due to threats to the domestic economy, namely SARS in 2001-2004 and the Great Financial Crisis in 2008-2010. The MAS maintained the neutral policy for an extended period given the dire straits the domestic and global economies were in. Once the economic and inflation outlook improved sufficiently and were on the uptrend, the MAS acted to remove the accommodative policy and shifted to a modest and gradual appreciation of the SGD NEER.

In the current episode, MAS provided itself and the economy with insurance against deterioration in the economy and prices when it eased policy twice since Jan 2015 and then to save these gains with a neutral policy in Apr 2016. So far, domestic growth has improved and could come in at the upper bound of the government's narrower 2-3% forecast range. While headline inflation remains soft, core inflation looks primed to creep higher underpinned by cyclical recovery and elevated global oil

prices. With core inflation poised to climb higher in 2017, maintaining a neutral policy could exacerbate inflationary pressures and have unintended consequences, especially if the recovery is accompanied by global reflation trades led by the US moves on tax reforms and fiscal spending.

The balance of risks appears to be biased towards inflation. Further extension of the neutral policy for longer than necessary could exacerbate inflationary pressures. Any concerns about growth and the labor market could be more aptly addressed by fiscal and manpower policies than exchange rate policy. Policy normalisation via a shift to a “slight appreciation bias” in Oct would be appropriate.

Regional Policy Divergence To Underpin SGD Strength

Tightening by MAS should be positive for the SGD, especially given that market is underpricing an adjustment by MAS. We could see the SGD extend its year-to-date gains against the USD since the start of the year. One-week SGD forward points suggest that market is positioning for no major surprises from MAS. We could thus see an outsize move by the SGD given that market is underpricing a policy adjustment by the MAS. The upmoves in the SGD could mitigate the drag from buoyant UST yields and USD underpinned by expectations of continuing Fed rate hikes and optimism over progress in US tax reform.

Currently, narrowing yield differentials with the UST is spurring outflows from the domestic debt market. However, Singapore bonds remain attractive to foreign funds given its relative high 10Y bond yield in the triple-A sovereign rating space. The move by MAS then would reinforce the attractiveness of Singapore debt and spur greater portfolio inflows and keep the SGD supported. We maintain our forecast for the USDSGD to come in around the 1.35-levels by end-2017, before climbing higher to 1.3550 and 1.3650 levels by end-1Q and -2Q 2018 and then to hover around the 1.37-levels in both 3Q and 4Q 2018.

Chart 4: Maybank USDSGD Forecast

Forecast	4Q 2017	1Q 2018	2Q 2018	3Q 2018	4Q 2018
USD/SGD	1.3500	1.3550	1.3650	1.3700	1.3700

Unlike its peers in the region, the shift in policy to a slight tightening bias would make the MAS the leader of the pack. ASEAN central banks remain on an easing bias or neutral policy for now, given growth concerns. Though all the ASEAN banks have room to tighten policy in 2018, only the Philippines looks poised to hike its benchmark policy rate. As for India, its twin deficits in the current account and fiscal balance amid rising inflation and slowing growth complicates policy making and could see the RBI hit the pause button on policy for now. Similarly, BOJ remains on an easy monetary bias and is expected to continue with its powerful monetary easing until its 2% inflation target is achieved around FY2019.

Against this backdrop of regional monetary policy divergence, SGD gains could still persist against other regional currencies but we see more pronounced strength against the INR and the JPY. We look for opportunities to long the SGD against short-INR and -JPY towards first objectives at 48.40 levels and 84.00 levels and then at next objectives at 49.00 and 85.00 respectively.

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