

FX Insight

SGD - No Time Like The Present To Normalise

Output Gap Turning Positive; Inflation On The Rise

The still healthy economic growth projected this year and next (our economics team forecasts growth of 3.1% and 2.5% in 2018 and 2019 respectively) should allow the mildly negative output gap to turn positive in 2H 2018 and 2H 2019. This suggests that the slack in the economy will dissipate and could put upside pressure on prices. This could signal that the current consumer price momentum could be sustained for the whole of 2018 and going into 2019. Our economic team has lifted its headline and core inflation forecast to 0.9% and 1.7% respectively in 2018 and then to 1.5% and 2.0% respectively in 2019. Already core inflation has risen above its five-year historical average of 1.3% since 2Q 2017, reaffirming our belief that inflation has legs to move higher. Some moderation in growth is expected, but economic growth show still expand by a healthy 3.1% for the whole of 2018 and then to 2.5% in 2019 as the synchronous cyclical recovery slows as projected by our economic team.

Taylor Rule Estimates Suggest Strengthening SGD NEER

Our Taylor Rule-SGD NEER estimates show that the SGD NEER is expected to strengthen ahead. Our estimates shows that the SGD NEER should end 2Q 2018 around 126.45 and then climb steadily towards 128.83 by end-2019. The implied USDSGD forecasts corresponding to the estimates ranges from 1.2864-1.3106. Though there appears room for MAS to hold until next year, we believe potential overheating risks, insurance to counter future downside risks and scrutiny on any MAS intervention to keep the SGD NEER from the upper bound of the policy band make normalising monetary policy by shifting to a modest and gradual appreciation path, the appropriate policy response for the MAS. Extending the neutral policy could exacerbate the upside pressure on inflation in 2019.

Maintain Our USDSGD Forecast For Now

We remain positive on the SGD underpinned by synchronous global recovery that could provide the catalyst for an investment-led growth and MAS move to normalise policy at its Apr meeting. Still, we cannot rule out possible further bouts of weakness that could lift the USDSGD higher if trade tensions intensify and geopolitical tensions on the Korean peninsula and Middle-East re-emerge. Nevertheless, we maintain our forecast for now expecting the USDSGD to hover around 1.27 by end-2Q before ending the year around the 1.24 levels. The pair should start 2019 on an optimistic note with the pair likely to end-1Q 2019 around 1.2200.

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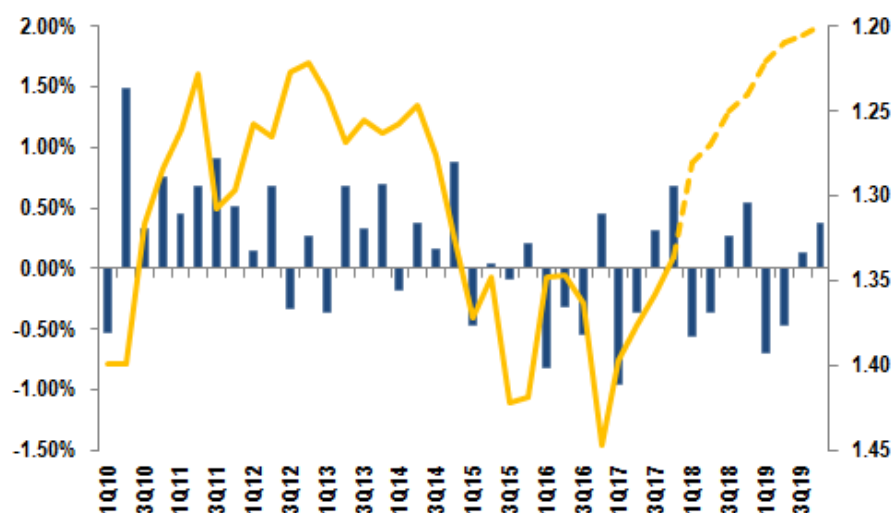
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Output Gap Turning Positive; Inflation Could Rise Further

The synchronous economic recovery in the region that begun in 2017 has extended into 2018. This has allowed the Singapore economy to outperform expectations and expand by 3.6% in 2017 vs. 2.4% in 2016. The strong growth momentum in 4Q 2017 is expected to continue into 1Q 2018 with our economic team penciling growth of around 4.2% y/y. Some moderation in growth is expected, but economic growth show still expand by a healthy 3.1% for the whole of 2018 slows as projected by our economic team.

The still healthy economic growth projected this year and the next should allow the mildly negative output gap expected in 1H 2018 to close and turn into a positive gap by end-2018 as suggested by our estimates (Chart 1). The moderation in growth in 2019 should all a mild negative output gap to re-establish but we expect this to eventually close and move into a positive gap in 2H 2019 as well.

Chart 1: Our Estimates the Output Gap Could Turn Positive By End-2019



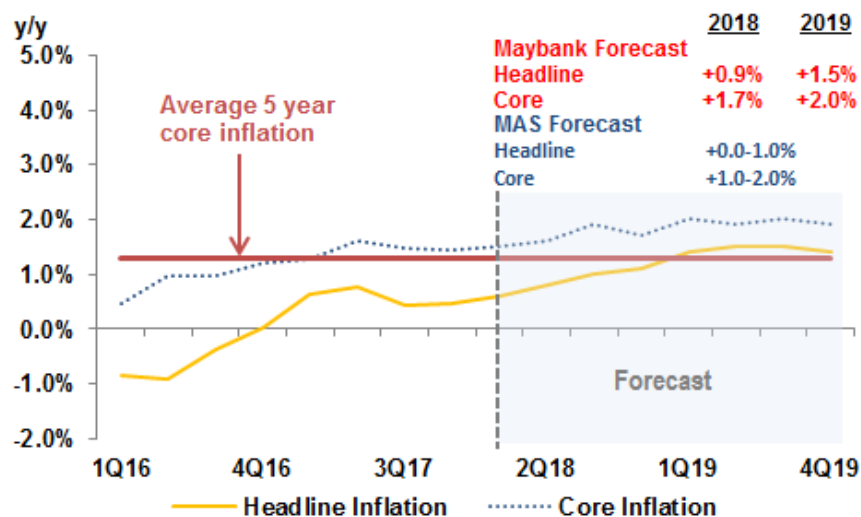
Source: Bloomberg, CEIC, Maybank FX Research

With the output gap turning positive in 2H 2018 and 2H 2019, suggesting that the slack in the economy will dissipate, upside pressure on prices is likely. This signals that the current consumer price momentum could be sustained for the whole of 2018 and going into 2019. Our economic team has lifted its headline and core inflation forecast to 0.9% and 1.7% respectively in 2018 (from 0.6% and 1.5% in 2017) and then to 1.5% and 2.0% in 2019 respectively (Chart 2). Already core inflation has risen above its five-year historical average of 1.3% since 2Q 2017, reaffirming our belief that inflation has legs to move higher.

Domestically, the ongoing tight foreign worker policy is set to get even tighter with the raising of qualifying salaries for S-passes in Jan 2019 and Jan 2020. Employment conditions are also poised to strengthen further in tandem with the economy with employment jumping by 12.7K in 4Q 2017, lifted by the services sector. Further improvement in employment

should put upside pressure on wages. Transport cost is also on the rise with fares for buses and MRT rides expected to climb higher.

Chart 2: Core Inflation Is Picking Up



Source: CEIC, Maybank FX Research

Meanwhile, oil prices could be pushing higher in 2018. Already Saudi Arabia has lifted the official selling price of oil its sells to Asia expectedly suggesting that there could be upside risks to global oil prices. Food prices could also be another source of upside pressure to domestic prices, given that Singapore imports most of its food stuff. Thought this could prove to be transitory, the UN FAO's world food price index is showing a healthy pick up for the past two months, suggesting that the rise in food prices may have legs going forward.

Taylor Rule Estimates Suggest SGD NEER Strength Ahead

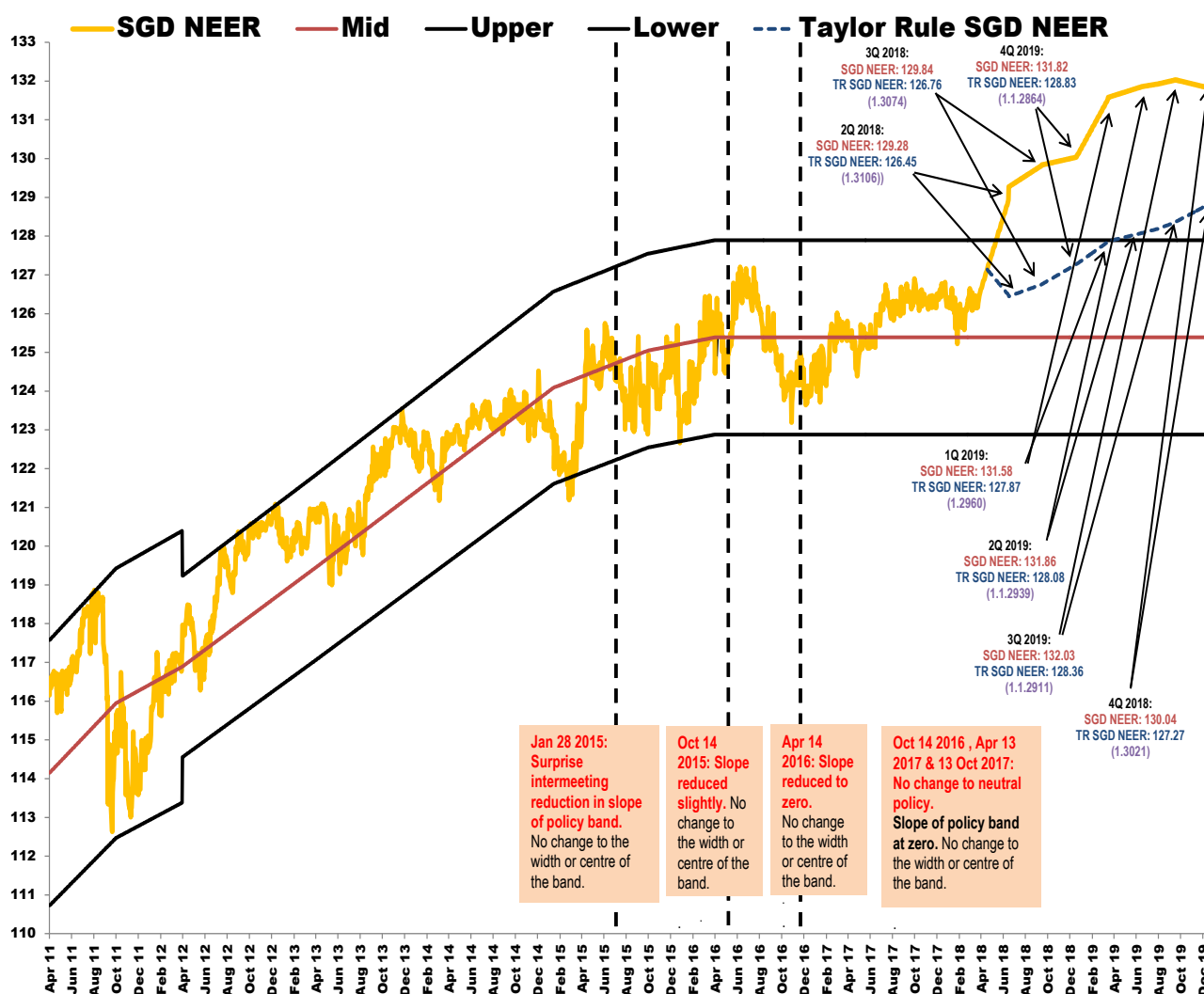
Our estimates for the SGD NEER using the Taylor Rule (growth and inflation trade-offs) suggests that the SGD NEER should strengthen ahead (Chart 3). SGD NEER is estimated to end-2Q at 126.45 before ticking higher to 126.76 in 3Q and then ending 4Q at 127.27. The SGD NEERS continues to climb higher in 2019, first to 127.87 in 1Q, 128.08 in 2Q, 128.36 in 3Q and 128.83 in 4Q. The implied USD\$SGD forecasts corresponding to these estimates are 1.3106 (2Q 2Q 2018), 1.3074 (3Q 2018), 1.3021 (4Q 2018), 1.2960 (1Q 2019), 1.2939 (2Q 2019), 1.2911 (3Q 2019) and 1.1.2864 (4Q 2019).

The Taylor Rule-SGD NEER estimates show that the SGD NEER will remain within the policy band until end-4Q 2018 and then move outside the band only in 1Q 2019. Some would argue that this suggest that MAS has room to remain on hold until its Apr 2019 meeting. We would argue that holding policy longer could dampen potential overheating risks, particularly with the negative output gap closing and eventually turning positive in 2H 2018 and 2H 2019. In addition, normalising policy sooner buys MAS insurance to counter future downside risks, particularly from geopolitical tensions and global trade disruptions from trade wars. Just

as important, the SGD NEER is steadily climbing towards the upper bound of the policy band and maintaining the current policy stance would require MAS intervention to keep the SGD NEER away from the policy band, especially in an era where intervention invites unnecessary scrutiny from its trading partners.

Thus, the appropriate policy response would be for the MAS to normalise monetary policy by shifting to a “modest and gradual appreciate” stance.

Chart 3: Our Taylor Rule-SGD NEER Estimates* Points To Stronger SGD NEER



Note that the yellow line is Maybank estimates of the SGD NEER, while the blue dotted line is our Taylor Rule-SGD NEER estimates.

*Estimated using GMM Model using an augmented Taylor Rule Framework

Source: Bloomberg, Maybank FX Research

MAS Easing Cycle Has Run Its Course

With the gap not only dissipating but turning into a positive gap in 2H 2018 and inflation, particularly core, is edging higher suggest that the current neutral policy of the MAS may no longer be appropriate. While there are risks to our growth scenario from potential trade wars, we do not think these will derail the current synchronised economic momentum. Our base case remains for China and the US to engage in negotiations to achieve an acceptable solution to the trade issues between the world's two largest economies. Thus, the risk of the MAS continuing with its current policy is that the central bank would have to play catch-up and tighten even more aggressively in the future.

Note that the MAS easing bias had begun in 28 Jan 2015 when it surprised with an inter-meeting decision to reduce the slope of the policy band while maintaining a modest and gradual appreciation stance. The rationale behind the decision then was the benign inflationary environment amid a sharp drop in global oil prices. The policy has been kept accommodative since that surprised move with the MAS reducing the slope twice more - once in Oct 2015 and then finally to zero percent slope in Apr 2016 where it has been maintained since.

Looking at the past two episodes where the MAS had shifted to a neutral policy, namely during SARS (2001-2004) and the Great Financial Crisis (2008-2010), once the economic and inflationary environment improved sufficiently, the MAS acted to remove the accommodative policy and shifted to a modest and gradual appreciation stance.

Not in a dissimilar vein from the two previous episodes, the current cycle that started in Jan 2015 was an insurance the MAS provided to prevent the economy from spiraling into a deflationary situation. The insurance appears to have been successful with the economy bouncing back to expand by more than 3.0% in 2017 after two years of 2.0% growth (in 2015 and 2016). Inflation too is creeping higher, particularly core, towards the 2.0% levels. As we had already noted, core inflation has come in above its 5-year historical average since 2Q 2017.

With growth momentum still underpinned by the global cyclical recovery and inflation poised to climb higher ahead, maintaining a neutral policy could exacerbate inflationary pressures and have unintended repercussions, especially amid a synchronous global recovery and near-convergence in monetary policy among the G7 economies (except for Japan).

Based on our analysis, the balance of risks remains tilted towards inflation. The synchronous global recovery still has legs to run and reinforced with the government's planned infrastructure building programme as laid out in the 2018 budget statement should keep the economy humming along. With the focus of MAS policy on inflation, the extension of the neutral policy for longer than necessary could exacerbate inflationary pressures. Policy normalisation via a shift to a "modest and gradual appreciation" stance at its semi-annual meeting on 13 Apr would be appropriate.

Maintain our USDSGD Forecast For Now

Markets appear to share our belief that the USDSGD is poised to move lower in the months ahead. Based on the forward points for the USDSGD, the market is positioning for further SGD strength ahead as seen in Chart 4 below. The 1-month, 3-month and 12-month forward points are all on the downtrend, particularly from Feb.

Chart 4: USDSGD Forward Points Point To Further SGD Strengthening Ahead



Source: Bloomberg, Maybank FX Research

We remain positive on the SGD underpinned by synchronous global recovery that could provide the catalyst for an investment-led growth and MAS move to normalise policy at its Apr meeting. Still, we cannot rule out possible further bouts of weakness that could lift the USDSGD higher if trade tensions intensify and geopolitical tensions on the Korean peninsula and Middle-East re-emerge. Nevertheless, we maintain our forecast for now expecting the USDSGD to hover around 1.27 by end-2Q before ending the year around the 1.24 levels. The pair should start 2019 on an optimistic note with the pair likely to end-1Q 2019 around 1.2200.

The difference between our implied USDSGD estimates and our USDSGD forecast suggests that the market may not be fully pricing in the risks of a MAS move with some participants expecting MAS to remain on hold for now. In addition, there could be some underestimation of USD weakness as embodied in the implied USDSGD estimates. We believe that the market would eventually move towards our forecast.

Forecast	2Q 2018	3Q 2018	4Q 2018	1Q 2019
USDSGD	1.2700 (--)	1.2500 (--)	1.2400 (--)	1.2200 (--)

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