

Forex Market Review and Outlook

~ USD/JPY and USD/CNH ~

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USD/JPY 2017 H2 Review

USD/JPY ranged between 107.3 and 114.7 in H2 2017. Similar to H1, the Fed's monetary policy normalization, proceeded with balance sheet reduction in October and followed by 25bps rate hike in December, failed to boost USD/JPY. The heightening speculation of hawkish Fed's next Chair lifted the pair but the nomination of centrist Powell stifled hopes for more aggressive Fed's rate hike pace next year. In addition, Trump's administration claimed the first victory in policy delivery after passing the tax bill in the Congress, but USD/JPY still failed to break above 114 level. Apart from the US factor, the mounting geopolitical tensions in North Korea was proved to be short-lived while Japan PM Abe's victory of super majority in early election and BoJ's Governor Kuroda's comment on reversal rate theory failed to rock the market.

USD/JPY 2018 H1 Preview

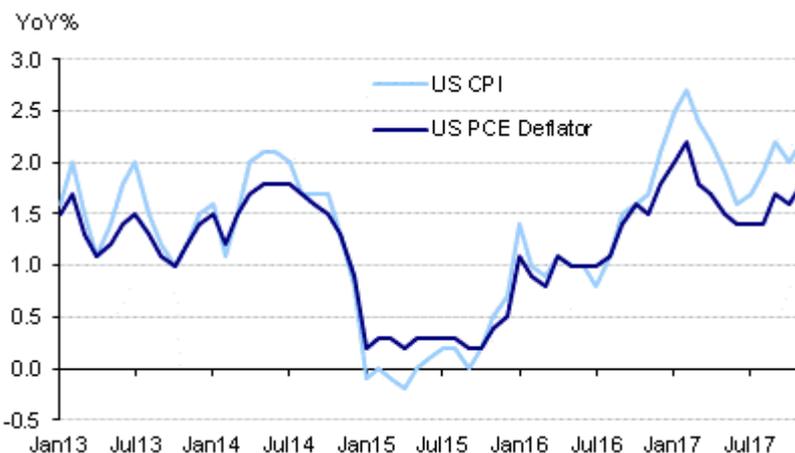
Given our soft USD view, we expect USD/JPY to drop gradually to 105 level at 2018-end (Fig. 1). In our view, the Fed will likely maintain its gradual rate hike pace under the new Fed's Chair Powell. Instead of expected US rate hikes in 2018, Fed's long-term rate projection which will be more decisive for USD/JPY movement and the soft US inflation outlook despite of US tax cut, as reflected by Fed's forecasts, would leave the long-term rate projection at low level (Fig. 2). Elsewhere, the BoJ is likely to keep its monetary policy unchanged as Japan inflation remains far below its 2% inflation target. BoJ's comment on reversal rate theory also raised the chance for lifting 10Y JGB yield target mildly, adding downside risks of USD/JPY. After all, the argument of JPY undervaluation by the measurement of current account and Purchasing Power Parity (PPP) model justifies our call for JPY rally.

Fig. 1: USD/JPY to fall back in 2018



Source: Bloomberg

Fig. 2: US inflation picked up but not sufficient to quicken Fed's rate hike pace



Source: Bloomberg

USD/CNH 2017 H2 Review

RMB depreciation expectation reversed after the CNY breaking below the 6.70 handle in August and subsequently the CNH spot set its 20-month fresh high of 6.4436. In order to calm down bullish RMB sentiment, the PBoC removed the required reserves on CNH deposit and 20% CNY forward risk reserves, which was interpreted as the signal to encourage RMB selling. Afterwards, the CNH entered into the two-way volatility mode and remained largely steady during the 19th Party Congress, Trump's visit to China and Fed's rate hike. In the meantime, the deleveraging continued, with M2 growth falling to its record low, and China Government Bond (CGB) came under heavy pressure. However, the CNH was resilient to sell-off in onshore equities and bonds markets and managed to close 6.5% higher in 2017.

USD/CNH 2018 H1 Preview

The CNH market is likely to remain steady in 2018 amid two-way volatility, with risk biased to the downside (Fig. 3). Following the 19th Party Congress,

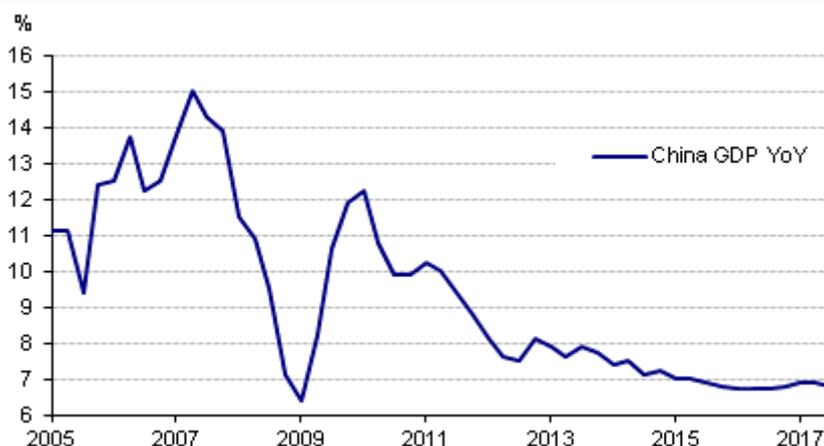
Chinese leaders are determined to push forward deleveraging and deepen structural reforms. Having downplayed the growth target, they strive to shift policy focus to more balancing growth with emphasis on environmental protection. This suggests softer growth momentum and tighter financial regulations in 2018 (Fig. 4). The resurfacing concern over China's growth and risk of excessive monetary policy tightening could pose downside risk to the CNH. Moreover, capital outflow pressure should remain intact despite of the dissipating one-way RMB depreciation expectation. Demand for overseas asset allocation from residents and capital repatriation due to rising production costs in China and US tax cut would result in capital outflow pressure, offsetting the capital inflow to China's onshore bond market, which is subjected to further open-up in coming years.

Fig. 3: Modest RMB depreciation for 2018



Source: Bloomberg

Fig. 4: China growth is set to slow down in 2018



Source: Bloomberg

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