

Forex Market Review and Outlook

~ USD/JPY and USD/CNH ~

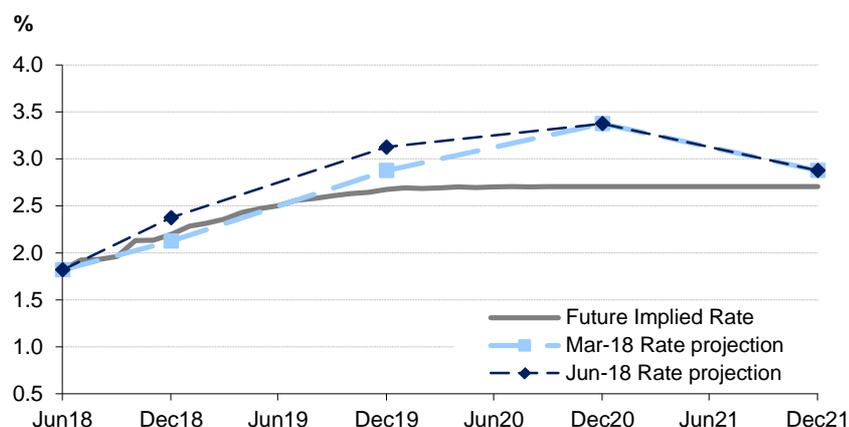
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USD/JPY 2018 H1 Review

USD/JPY extended its downtrend in Q1-18, on worsening US fiscal balance post tax cut and heightening speculation on the beginning of BoJ's QE exit. Heading into Q2, the pair reversed its decline and rebounded to above 110 level from its 20-month low of 104.56, on more upbeat US inflation outlook and aggressive Fed's tightening pace. In June, Fed lifted its target rate by 25bps for the second time this year, and revised upward the whole year rate projection to 4 from 3 times (Fig. 1). There was recoupling of the correlation between USD/JPY and UST yields. Consequently, the soaring 10Y yield, which hit its 7-year high of 3.126%, pushed the currency pair higher. In addition, risk aversion drifted lower as geopolitical tensions in North Korea eased considerably following the historic Moon-Kim Summit and Trump-Kim Summit. Fears of trade war and Eurozone woes spiked but were proved to be short-lived after all. In Japan, Abe's Cabinet's popularity collapsed on the land scandal, fuelling discussion over end of Abenomics, but so far the market impact was rather limited.

Fig. 1: The Fed revised upward rate projections over past two meetings



Source: Bloomberg

USD/JPY 2018 H2 Preview

We maintained our view that USD/JPY will gradually fall to 100 level (Fig. 2). For the USD side, the Fed may reach the peak of current rate hike cycle next year. In June, the Fed left its longer-term rate projection unchanged at 2.875%, which is regarded as Fed's target rate to achieve. This suggested limited room left for further rate hikes in coming years. We reckon that even two more rate hikes in H2 are not able to fuel upside momentum of USD/JPY. Moreover, concern over worsening US fiscal balance and Trump's weak USD policy implied by his protectionist stance could resurface and weigh on USD/JPY. The US mid-term election outcome will shed light on the outlook of Trump's presidency, and mounting political uncertainties boost safe-haven demand for JPY. For the JPY side, the possibility of ending Abenomics could fuel speculation of ending BoJ's aggressive monetary easing led by Abe's close allies of BoJ Governor Kuroda. The sliding popularity of PM Abe's Cabinet risks his leadership in Liberal Democratic Party (LDP) election in September. After all, it would be too early for the BoJ to begin QE exit this year as inflation remained well below 2% target. However, any speculation of BoJ's plan to exit QE and JPY's strong fundamentals should keep the JPY supported throughout the year.

Fig. 2: We maintain our call of USD/JPY decline to 100 at year-end



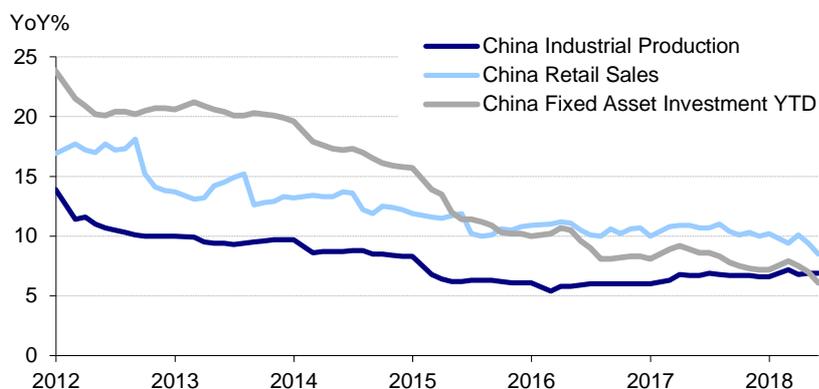
Source: Bloomberg

USD/CNH 2018 H1 Review

The CNH strengthened further in the beginning of year, as capital inflow for buying onshore equities and bonds accelerated given more upbeat China growth outlook. Subsequently, the CNH rallied as much as to 6.2361, the strongest level since the CNY fixing reform in August 2015. With steady RMB sentiment, PBoC removed the RMB stabilizing measures including the counter cyclical factor in CNY fixing rule and resumed the RMB internationalization plan, with the launch of RMB crude oil future in March. In the meantime, the CNH market was largely muted with the change of PBoC leadership, with long-served Deputy Governor Yi Gang replacing retired Zhou Xiaochuan as new PBoC Governor. In Q2, the mounting China-US trade tensions, softening China data (Fig. 3) and USD rebound started to weigh on the CNH, and the pair retreated to near 6.40 level. Besides, the

A-share inclusion in MSCI brought some passive capital inflow but the amount was not sufficient to boost the CNH.

Fig. 3: China growth momentum is slowing down



Source: Bloomberg

USD/CNH 2018 H2 Preview

We expect the CNH to remain steady in H2, ranging between 6.2 and 6.6 level throughout the year (Fig. 4). Despite the downplay of growth target by Chinese leaders, China fundamentals remained fairly stable and the RMB market should be more resilient to USD rebound and global monetary tightening among EM currencies. The risk of China-US trade tensions should be contained as the trade war was being averted and a currency war for competitive currency depreciation was unlikely. Going onward, China is to stick with its plan for capital account liberalization and RMB internationalization. While capital outflow pressure in China was contained, capital inflow from global FX reserves diversification alongside the open-up of China onshore bond market will likely keep the CNH supportive. We expect PBoC to maintain its neutral and prudent monetary policy stance with higher flexibility in liquidity management, with the possibility of targeted Required Reserve Ratio (RRR) cut later this year. Hence, the RMB movement would depend more on global monetary tightening pace rather than the rigid China monetary policy stance.

Fig. 4 CNH to stay steady in 2018



Source: Bloomberg

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