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Forex Market Review and Outlook

~ USD/JPY and USD/CNH ~

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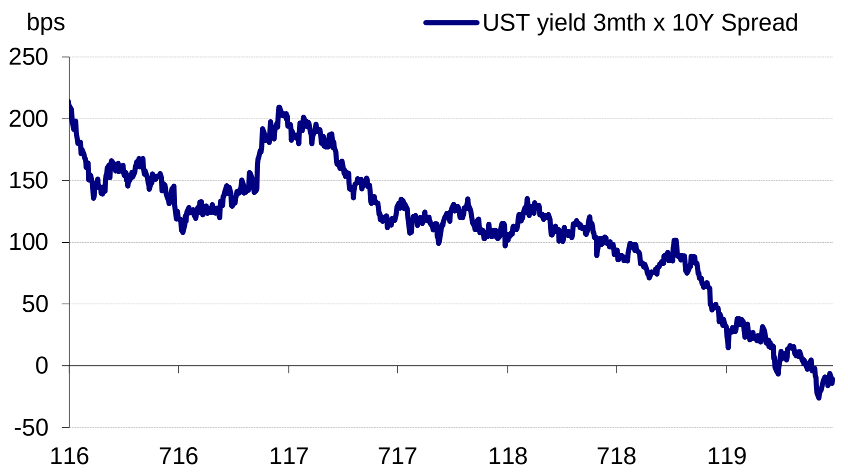
USD/JPY 2019 H1 Review

USD/JPY rebounded to as much as to 112 level after the flash crash to 104.87 in early January. Alongside the positive development in China-US trade negotiations, the Fed turned more neutral and safe-haven demand retreated. While market expected China and US to make a trade deal soon in May, Trump suddenly reversed its course and implemented tariffs hikes to 25% on USD 200bn Chinese goods. The re-escalation of China-US trade tensions frightened investors and interest rate market priced in Fed's rate cut cycle to kick off later this year. Subsequently, Fed's Chair Powell dropped the patient approach while pledged to deliver a faster action to support labour market and inflation meeting with the mandate. 10Y UST yield tumbled to around 2.0% from 2.6% in Q2 on mounting trade war risk and Fed's rate cut expectation, while UST yield curve partially inverted again, with 3-month/10Y spread falling to the most negative level since Global Financial Crisis (See Fig. 1).

Fig. 1: Inverted UST yield curve projecting Fed's rate cut

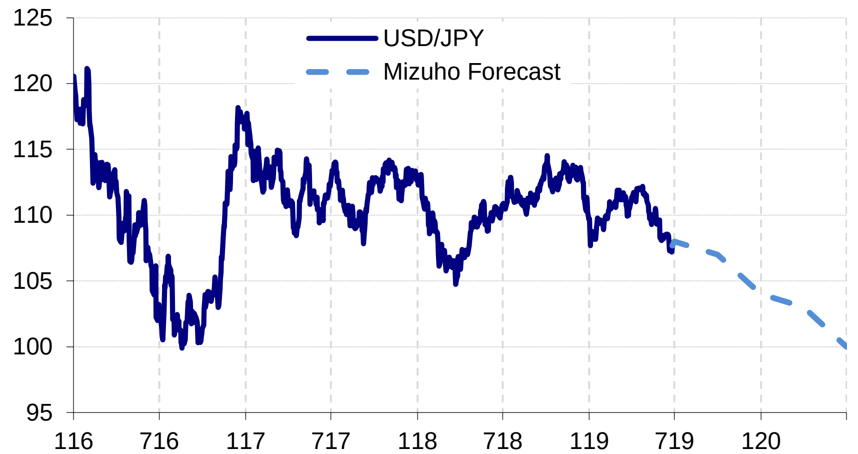


Source: Bloomberg

USD/JPY 2019 H2 Preview

We expect USD/JPY to fall back to 104 at 2019-end as the resuming trade war risk will likely bring the Fed's rate cut forward, which will weigh on the USD/JPY (Fig. 2). The broader-based trade war had sparked the sell-off in high-tech sector and any equities rebound due to Powell's put are likely to prove short-lived. The falling US equities amid rising US recession risk will probably heighten demand for safe-haven. For the BoJ policy, Governor Kuroda said the BoJ had room for big stimulus and was wary of side effects as well. We expect the BoJ to stay put unless the Japan economy fell into recession following consumption tax hike to 10% in October or amid increasing trade war risk. However, the sooner Fed's rate cut, which could in turn translate into excessive JPY strength, could bring forward BoJs easing.

Fig. 2: Trade war risks and soft USD to drag USD/JPY to 104



Source: Bloomberg, Mizuho Bank (*as of 26 Jun. 2019)

USD/CNH 2019 H1 Review

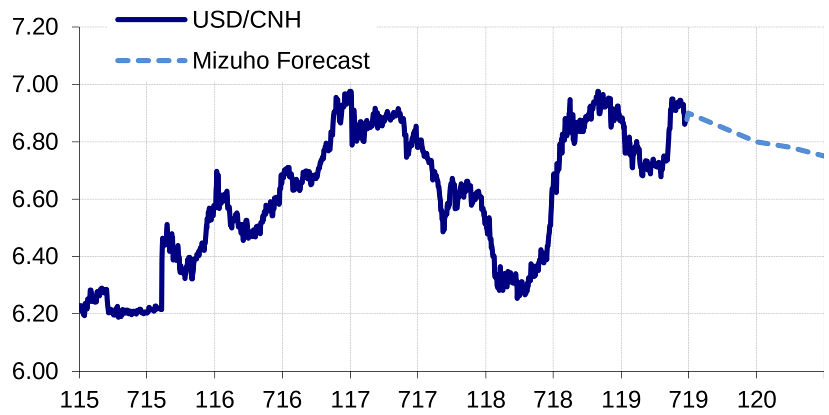
The CNH recovered amid the positive development of China-US trade talks, settling at near 6.7 level since March. The surprising robust Q1 GDP figure and capital inflow following the inclusion of China equities and bonds into global indices given the RMB stability also helped propel the CNH. However, the CNH broke its equilibrium and plummeted to near 6.9 in early May as Trump surprisingly raised tariffs to 25% on USD 200bn Chinese goods. China-US tensions re-escalated shortly as China retaliated with tariffs hikes. The US's blacklisting of China telecom equipment manufacturer Huawei and the potential ban on rare earths exports to US by China also fueled concern over the fallout of trade tensions to the high-tech sector. On the policy front, the PBoC maintained the FX stability in the near term via steady CNY fixing, verbal FX intervention and PBoC's bill issuance in HK while attempted to downplay the significance of psychological 7 level in the medium term.

USD/CNH 2019 H2 Preview

The re-escalation of China-US tensions and the threat of full-blown trade war will likely weigh on the RMB exchange rate. Further US tariffs hike on Chinese goods will also fueled speculation that China will allow more RMB depreciation to counter tariffs impact, while capital outflow pressure will likely intensify given the bearish RMB outlook. Admittedly, hopes for a ceasefire should be slim unless either China or US suffered loss from the trade war, and the China-US conflicts could evolve into an endurance test.

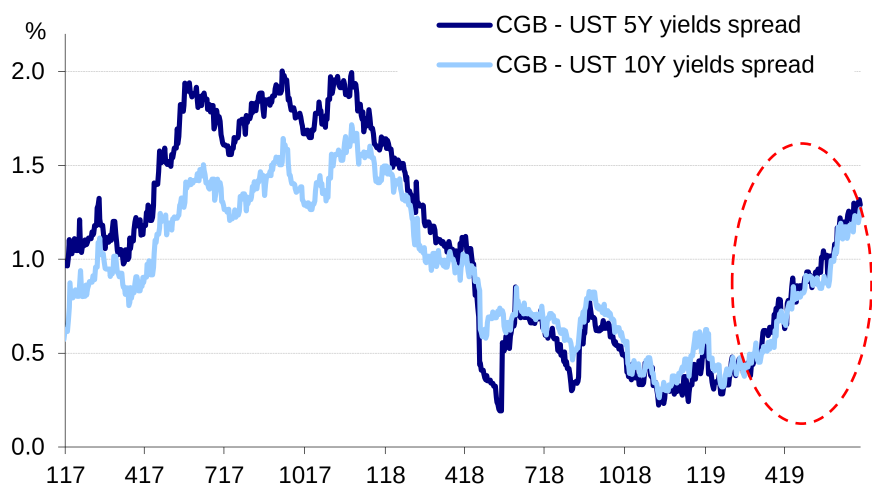
However, we expect the CNH to stabilize on its robust fundamentals subsequently after the digesting the trade war factor (Fig. 3). Taking into account the strong fiscal stimulus via taxes and fares cut, China growth outlook should prove to be more resilient and the PBoC has less urgency to lower its policy rates. Meanwhile, the trade war risk would likely bring forward Fed's rate cut to this year and favourable PBoC-Fed monetary policy divergence and peaking USD will likely help support the RMB exchange rate (Fig. 4).

Fig. 3: CNH to stabilize after digesting trade war factor



Source: Bloomberg, Mizuho Bank (*as of 26 Jun. 2019)

Fig. 4: More favourable CGB-UST yield spread on RMB



Source: Bloomberg

On the policy front, the PBoC will continue to downplay the significance of psychological 7 level and help market participants digest such level. We believe that the PBoC will eventually loosen its grip on 7 level and allow more FX flexibility as long as the RMB depreciation overshooting and capital outflow risk are being contained.