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Forex Market Review and Outlook

~ USD/JPY and USD/CNH ~

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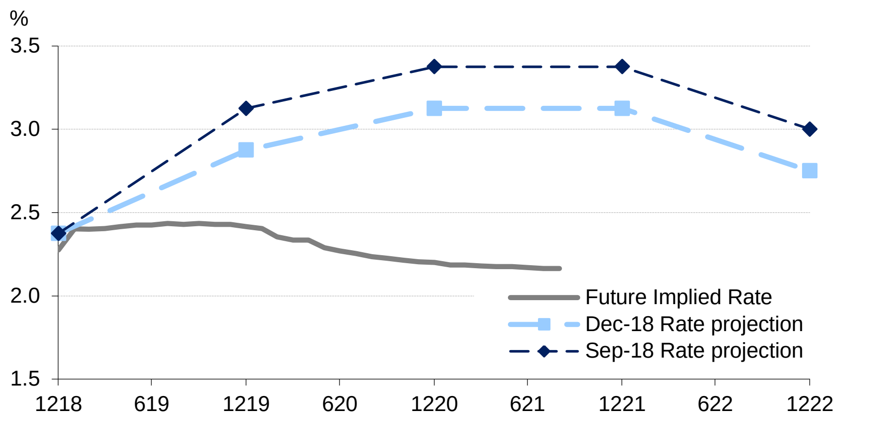
USD/JPY 2018 H2 Review

USD/JPY climbed gradually to its 11-month high of 114.55 before falling back to mid-110 on mounting risk aversion at year-end. Broadly speaking, USD/JPY entered into range trading on the counteracting forces of strong USD and risk aversion in the period. With Trump's tax cut stimulus, the accelerating US growth warranted Fed's gradual rate hike. Together with capital repatriation flow triggered by the tax holiday, they pushed USD/JPY higher despite the mounting China-US trade tensions.

The hawkish Fed once sent 10Y UST yield to its 7-year high of 3.259%, but eventually the UST yields stopped surging and UST yield curve partially inverted, fueling concern over US recession thus triggered heavy sell-offs in US equities. In November, the Fed made a dovish shift and subsequently cut its rate projection for 2019 after the December rate hike (See Fig.1). However, it failed to calm the market and USD/JPY fell back to mid-110. Meanwhile, USD/JPY largely muted with the US mid-term election and the ceasefire in China-US trade war at the G20 Summit.

Fig. 1: The Fed cut its rate projection while rate market priced in modest rate hike chance

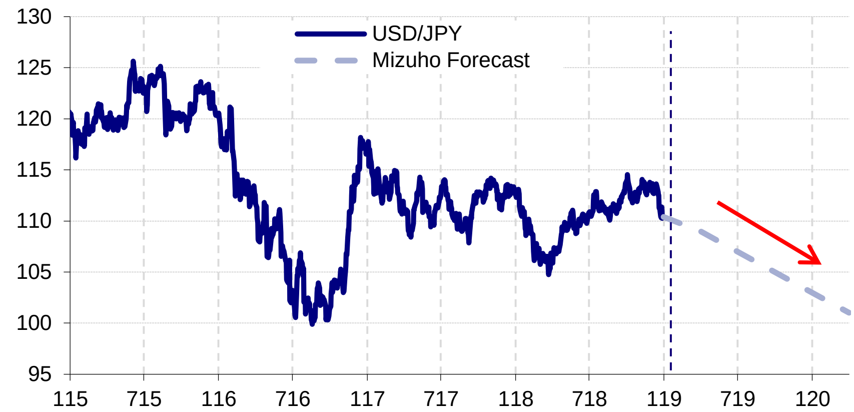


Source: Bloomberg

USD/JPY 2019 Preview

We expect USD/JPY to decline gradually to 103 at 2019-end as the Fed will probably pause its rate hike cycle on peaking US growth momentum (Fig.2). With Republicans losing control over House of Representative in the mid-term election, another round of tax cut by the Trump administration in coming two years looks unlikely. The materializing negative impact from trade war, as well as Fed's tightening of rate hikes and balance sheet reduction will also likely drag on US growth. Moreover, the increasing US political risks rising from US government shutdown, concern over Fed's independence and Mueller's Russia investigations cast a cloud over USD outlook. For JPY, the BoJ is set to leave its policy unchanged in 2019 given the scheduled sales tax hike in October. The soft CPI inflationary pressure and threat of negative JGB yield suggest that the BoJ will be in no hurry to raise policy rate. After all, the falling global equities would fuel risk aversion and the safe-haven flow would keep the JPY supportive.

Fig. 2: We expect USD/JPY to decline to 103 at year-end

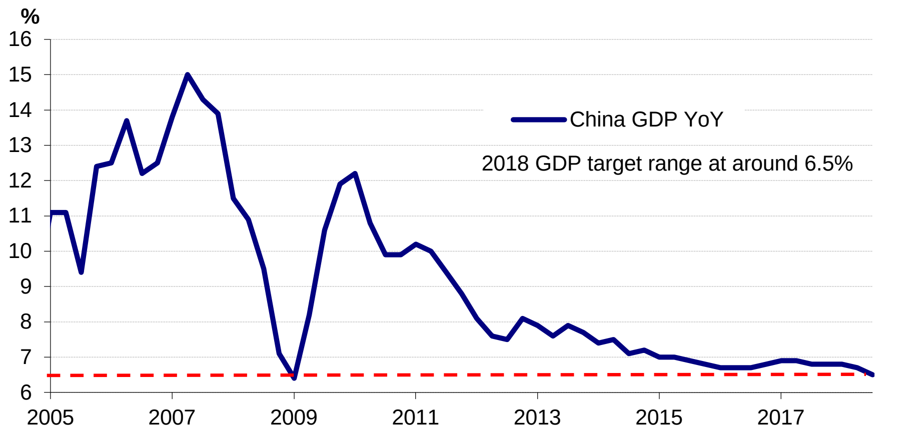


Source: Bloomberg, Mizuho Bank (*as of 31 Dec. 2018)

USD/CNH 2018 H2 Review

Since June, the CNH spot plummeted to around 6.9 level within 2 months amid the rising risk from China-US trade war. Initially the PBoC adopted the non-intervention policy and might have allowed RMB depreciation to counter the US tariffs impact. With increasing capital outflow risk, the PBoC took action to stabilize the RMB market. The return of counter cyclical factor in CNY fixing setting slowed down the RMB depreciation pace and the PBoC managed to prevent the CNH from breaking above 7 psychological level on suspected FX intervention in Q4-18. Dramatically, China and US agreed on a temporary ceasefire on escalating US tariffs to 25% on USD 200bn of Chinese goods in the G20 Summit at November-end. The CNH took a relief and rebounded to 6.8260 before settling at near 6.90 at year-end. Fundamentally, China growth outlook continued to deteriorate, with Q3 GDP growth decelerating to its 10-year low of 6.5%YoY (Fig.3). The PBoC added its easing bias and delivered 2 rounds of targeted Required Reserves Ratio (RRR) cut in H2-18 to keep liquidity ample. The PBoC-Fed monetary divergence continued to weigh on the CNH.

Fig. 3: China GDP growth hit its 10-year low

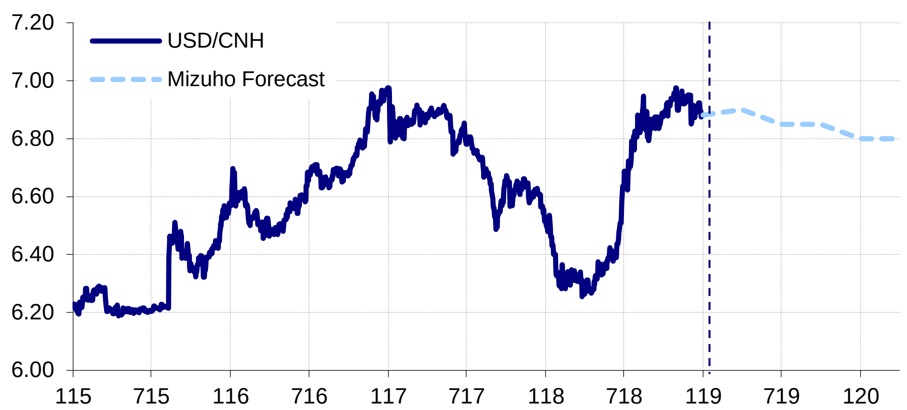


Source: Bloomberg

USD/CNH 2019 Preview

The CNH is expected to stabilize in 2019, with our year-end target of 6.8. Some of the market participants have prepared for further escalations in China-US trade war. The first deadline for 90-day China-US trade talks will be on 1st March 2019. While reaching a comprehensive deal within such short period will be challenging, a deadline extension will be a more likely result. With broadening trade dispute between the US and China, China-US tensions are set to continue in 2019. The silver lining is that Trump could start to lose the upper hand in trade talks if the US economy enters into a downturn. Second, PBoC-Fed's monetary policy divergence will likely suppress the RMB appreciation. We expect the Fed to pause its rate hike cycle in 2019 but the PBoC is not going to give up its easing bias given darkening China growth outlook. The meaningful RMB recovery will only offer the PBoC a window of opportunity to deliver rate cut to support the economy. After all, the PBoC is likely to prioritize the RMB stability before reaching a trade deal with the US. Subsequently, the PBoC will allow higher two-way FX volatility and let the RMB breaking above 7 handle briefly before rebounding to 6.8 handle at year-end.

Fig. 4: CNH to stabilize in 2019



Source: Bloomberg, Mizuho Bank (*as of 31 Dec. 2018)