Mizuho Bank, Ltd., Hong Kong Corporate Banking Department No.1
China ASEAN Research & Advisory Section

South China – Asia Business Report
July 2017

Forex Market Review and Outlook

~ USD/JPY and USD/CNH ~

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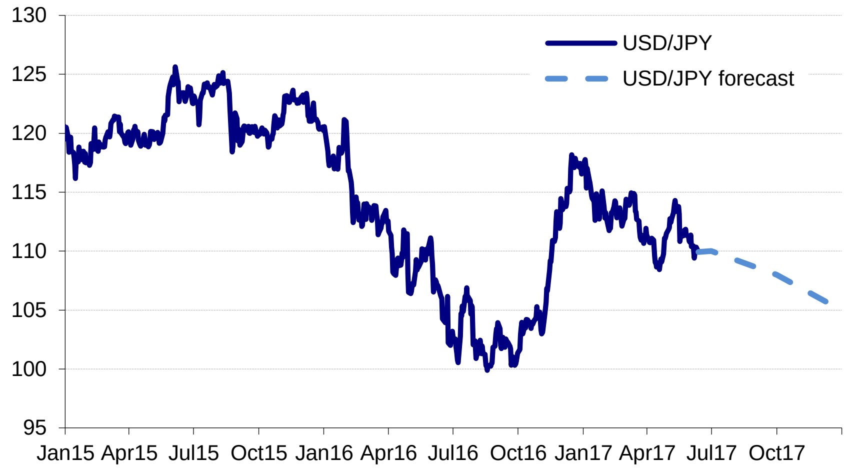
USD/JPY 2017 H1 Review

USD/JPY gave up its gains largely since Trump's victory in the US President Election, falling back to its 6-month low of 108.13 before settling at around 110 level. The collapse of Trump's trade was the main driver. Following his inauguration late January, market confidence on his policy delivery continued to deteriorate, in particular with his failure to pass the health-care bill in March. Worse still, his political turmoil intensified after he sacked off the former FBI Chief Comey who was investigating the Trump-Russia connection during the election campaign. In the meantime, stimulus impact from the tax cut plan and infrastructure construction is only expected to materialize next year. In addition, mounting geopolitical tensions in North Korea sent USD/JPY to mid-108 level briefly. Moreover, Fed delivered 2 times of 25bps rate hike in H1 which were well digested. Fed also talked about the shrinking balance sheet plan but the market impact was largely muted. Elsewhere, the BoJ maintained its monetary policy unchanged as inflation remained far below its 2% target.

USD/JPY 2017 H2 Preview

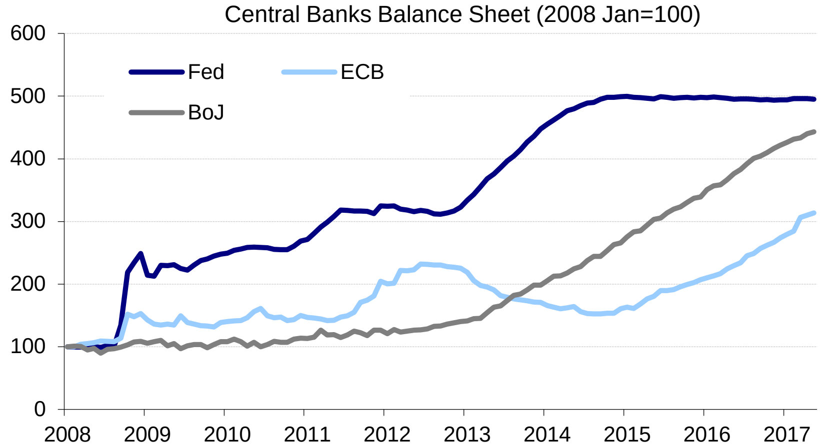
In 2017, we expect USD/JPY to extend its downtrend to 105 level by 2017-end on the collapsing Trump's trade and less hawkish Fed (Fig. 1). In addition to the collapsing reflation trade due to delayed policy delivery, the intensifying political turmoil would undermine Trump's political capital to execute reform, or would even make his impeachment impossible. Trump's policy mix is also in conflict. Given his protectionist stance, he favors a weaker USD and would continue to talk down the USD if necessary. The currency manipulator labelling in the US Treasury semi-annual FX report will remain in focus. All in all, such policy would offset the inflationary pressure from fiscal stimulus. Moreover, Fed is expected to turn less hawkish after 2 rate hikes in H1, given no imminent inflation pressure. Energy prices had lost their upside momentum while wage growth pressure remained modest despite the sanguine labor market. Instead Fed will likely shift the focus in its plan to shrinking balance sheet at gradual pace (Fig. 2). We look for no Fed's rate hike in H2.

Fig. 1: USD/JPY to fall further in H2



Source: Bloomberg

Fig. 2: Fed is to shrink balance sheet size in later 2017



Source: Bloomberg

USD/CNH 2017 H1 Review

RMB sentiment has improved considerably in H1, with easing capital outflow pressure, cooling China-US tensions and solid Q1 growth data. In early January, the PBoC was suspected to use offshore liquidity squeeze to defend the CNH spot. Subsequently the CNH spot surged from the low of 6.9895 to mid-6.78 within 3 days. In order to resume the RMB internationalization, China might have engineered another round of liquidity squeeze in May and pushed the CNH to its 6-month high of 6.7234. Additionally, China reportedly eased its capital outflow controls in April given improved RMB sentiment. In the meantime, market took relief on the RMB outlook as the US declined to label China as currency manipulator. US President Trump also showed his friendly attitude to China President Xi during Xi's visit to the US. Trump claimed that he would work with China to deal with the North Korea issue. After all, China Q1 data was surprisingly strong, with Q1 GDP growth accelerating to 6.9% YoY. This demonstrates receding downside risk of China's growth and prompts China's leaders to shift focus towards deleveraging from growth support.

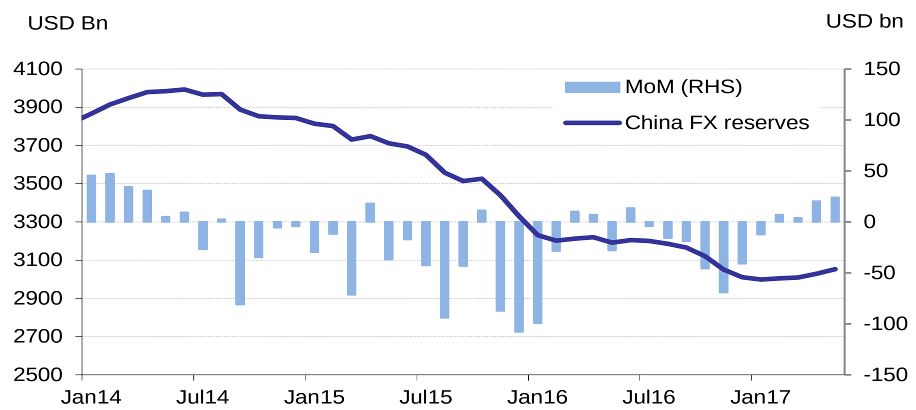
USD/CNH 2017 H2 Preview

We expect the RMB to stabilize throughout 2017 and a sharp RMB depreciation is unlikely to repeat (Fig. 3). Broadly speaking, China has resumed its RMB internationalization following the regression over the past year. As such, China attempted to reverse the RMB depreciation expectation to raise foreign investors' appetite on RMB denominated assets. In addition, as China's FX reserves gradually stabilized (Fig. 4), China will ease capital outflow controls further and allow more foreign investors to participate in the onshore China financial market, which could make RMB market more exposed to international capital flow. Hence, the PBoC considered adding the "counter cyclical factor" in the CNY fixing formula in order to tighten its grip on FX side. Consequently we expect the RMB to stabilize in the near term but the relaxation of capital outflow controls will unleash the pent-up outflow pressure and in turn push the CNY to reach 7.0 handle. Moreover, China will likely stabilize the FX market again during the 19th Party Congress due in autumn later this year.

Fig. 3: Resurfacing capital outflow to put RMB under pressure

Source: Bloomberg

Fig. 4: China FX reserves stabilized in 2017



Source: Bloomberg