

Forex Market Review and Outlook

2016 2nd Half and 2017 1st Half, USD/JPY and USD/CNH

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USD/JPY 2016 H2 Review

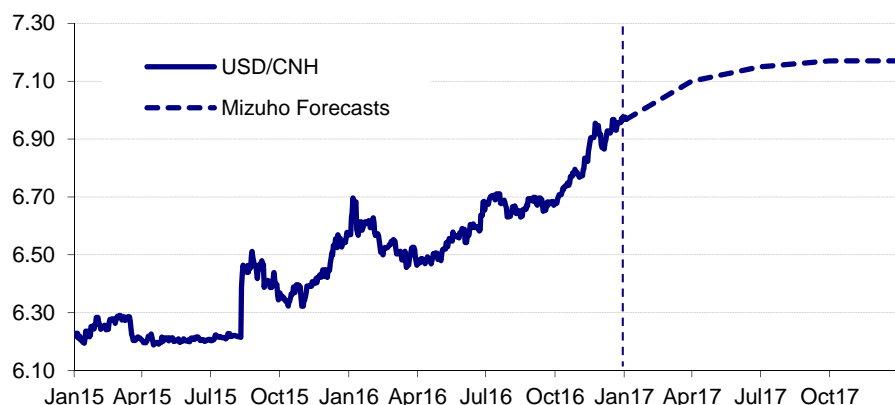
USD/JPY tested the 100 handle for several times as the Bank of Japan (BoJ) refrained from conducting FX intervention and easing further in monetary policy. With limited room for QE expansion and rate cut, the BoJ changed its policy framework to 'QQE with yield curve control' in September 2016 and targeted the 10Y JGB yield at 0%. The BoJ also strengthened forward guidance with "inflation-overshooting commitment", saying that it will expand monetary base until CPI inflation exceeds its 2% target and stays above 2% in a stable manner. The turnaround in USD/JPY was the surprising Trump's victory in US President Election on 9th November. Following the initial sell-off in USD/JPY, market mood turned dramatically from panic to buoyant and built up strong expectation on Trump's aggressive fiscal expansion to boost inflation outlook. The upbeat inflation outlook and deepening budget deficit triggered a heavy sell-off in US Treasuries, with 10Y UST yield soaring from the low 1.71% to 2.63%. Together with the Fed's rate hike in December and upward revision in rate projection to 3 rate hikes in 2017, USD/JPY surged from 101 to 118 in 6 weeks.

USD/JPY 2017 H1 Outlook

In 2017, we expect USD/JPY to lose upside momentum and fall back to 112 at H1-2017 end as US President-Elect Trump would under-deliver his policy plan after his inauguration on 20th January (Fig.1). With his posture as a protectionist, Trump should favor weakening USD to protect the export and manufacturing sectors. It will be a possible case for the Trump's administration to talk down the strong USD in the G20 Finance Minister meeting held in March and Semi-Annual Report on International Economic and Exchange Rate Policies. In addition, it is likely that the Fed will find difficulties to normalize the monetary policy in 2017. Under the widening monetary policy divergence, the USD will soar with Fed's rate hike and such strong USD appreciation is a form of monetary tightening. Furthermore, the expectation of Trump's fiscal expansion is running ahead of the curve. While

the stimulus is only likely to materialize in late 2017, the USD appreciation and soaring UST yields have already tightened the monetary conditions in early 2017. Under this circumstance, the Fed should be only able to raise its rate at a gradual pace.

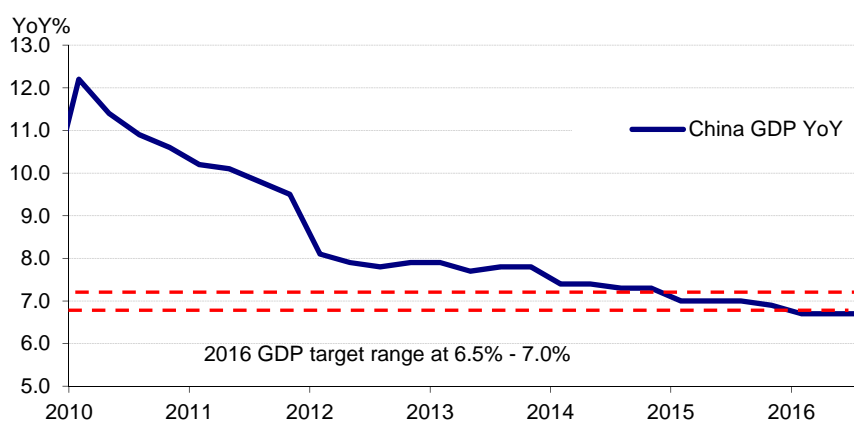
Fig. 1: USD/JPY upside momentum is unlikely to sustain



Source: Bloomberg

In Japan, the BoJ is likely to stay on hold in H1 2017 as the JPY strength is no longer the main concern for the BoJ since the JPY has depressed because of Trump's victory. Haruhiko Kuroda, the BoJ Governor, said that it is too early to discuss raising policy rates or JGB yield target. Fundamentally the widening UST-yield differential and lingering overseas direct investment due to shrinking domestic market will keep the USD/JPY supported (Fig.2).

Fig. 2: Widening UST-JGB yield differential kept USD/JPY supported



Source: Bloomberg

USD/CNH 2016 H2 Outlook

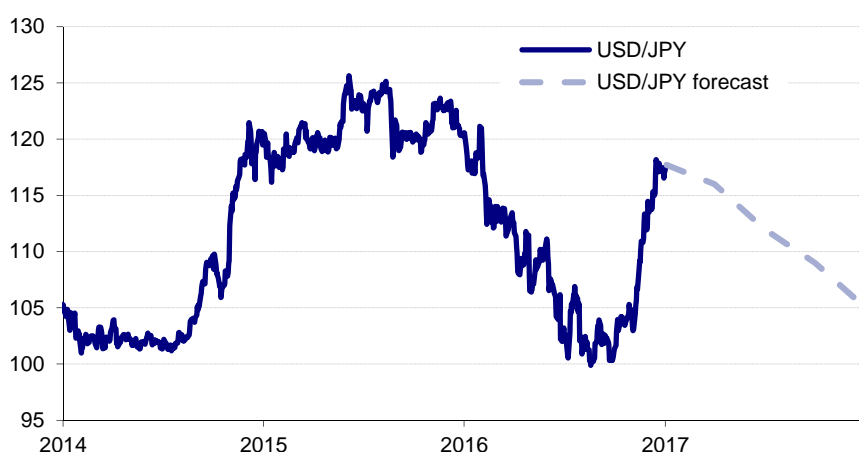
Following the stabilization around the G20 Summit, the CNH dropped further when the People's Bank of China (PBoC) set the CNY fixing above 6.7 after the official RMB inclusion in the SDR basket in early October and subsequently collapsed to the record low of 6.9873 on the sharp USD rally after Trump's victory in mid-November. Eventually, the CNH closed at near 6.97 at 2016-end, marking around 6.2% loss over the year. In order to defend the CNH, the PBoC might have attempted to use the liquidity squeeze to raise the carry costs of short CNH position and tightened the capital outflow control. Media reports that the State Administration of Foreign

Exchange (SAFE) is said to be strict the approval of the outward investments to curb capital outflow. Residents in mainland China also face difficulties to allocate their capital to overseas markets as investment insurance purchase via China UnionPay has been banned.

USD/CNH 2017 H1 Preview

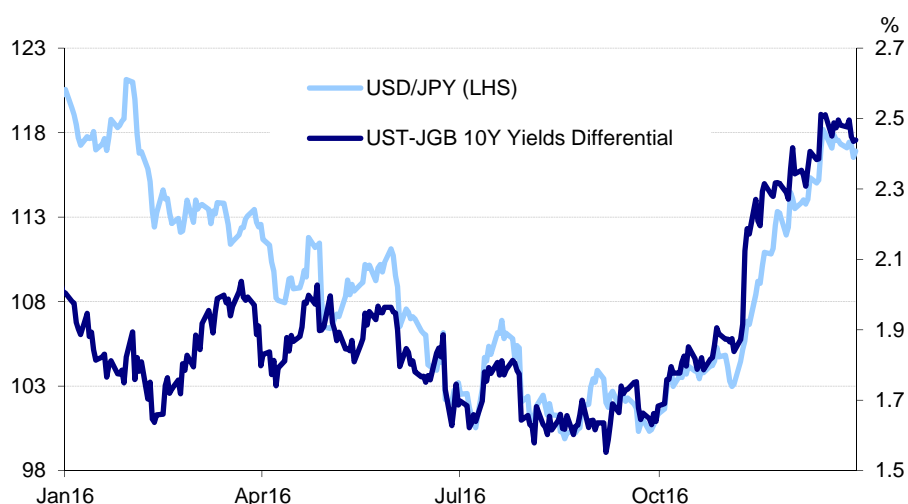
Looking forward, CNH depreciation is set to continue in 2017 on structural capital outflow from China and extension of USD rally in H1 (Fig.3). The current capital outflow is structural due to the economy transition and capital outflow pressure is unlikely to ease in 2017. Given the growth moderating to below 7% from above 10% in the past decade and soaring production costs including rental and labor costs, foreign investors are getting more difficult to find investment projects with attractive returns (Fig.4). Alongside RMB depreciation expectation, it is hardly surprising for FX loss incurred foreign investors to rush to repatriate capital back to their home country.

Fig. 3: RMB depreciation pressure returned since May 2016



Source: Bloomberg

Fig. 4: China's double-digit growth age has been gone



Source: Bloomberg

In the meantime, the diversification demand for asset allocation among

Chinese residents remains robust. The lack of proper investment channels causes domestic residents to sell their overvalued assets in China and purchase overseas assets elsewhere. Specifically, investors' confidence on the China stock market has not yet recovered after the stock market crash in 2015 while the recent China bond market rout and scandal reveal the risk of inadequate investor protection. The property market also looks overheated and the tightening measures have been implemented in early October. The robust RMB depreciation expectation just further adds more fuels on asset diversification demand. In response, the Chinese authorities will continue keep the capital outflow control measures tight, which will guide the RMB depreciation at a modest pace. Together with our view that the USD upside momentum is unlikely to sustain, the CNH will fall to 7.17 in H1 2017 and then stay steady at the same level at 2017-end.

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