31 March 2016

Essential Asia

National Australia Bank

In this issue

The RMB Fog Clears 1

Asian FX ride the USD slide 2

China Spotlight: New FX regime still a bit of a "basket" case 3

Korea Spotlight: Feeling vulnerable 4

India Spotlight: INR to drift amidst GST limbo 5

Singapore Spotlight: Time to get fiscal 6

Selected Indicators 7

The RMB Fog Clears

Talking Points

- **Return of risk appetite has seen Asian currencies strengthen across the board but still lag DM currencies.**
- **We have adjusted our forecasts to take into account the changing environment.**
- **The rebound in the oil price seems to have stalled, Brent has retraced from highs of just below USD 42/bbl.**
- **China's new FX regime appears to be getting clearer, with the RMB Index appearing to be positively correlated with the DXY.**

Recent Reports

- 30 March 2016 – Japan Economic Outlook
- 14 March 2016 – Asia Dashboard: Malaysia
- 13 March 2016 – China's economy at a glance

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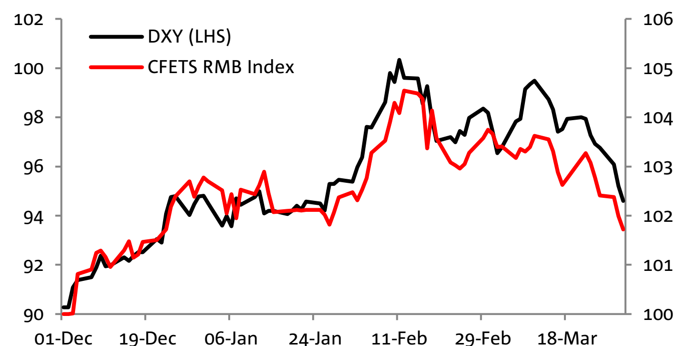
Trade recommendations

Entry date	Currency pair	Trade	Opening level	Target	Stop
17 Mar 2016	SGD/MYR 6m NDF	Long	3.0047 (spot)	3.2000 (spot)	2.8850 (spot)

Chart of the month: RMB Index guided in line with DXY



Source: NAB, Bloomberg

Policy Rates

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Korea	1.50	1.50	1.75	2.00	2.00
Thailand	1.50	1.50	1.50	1.75	2.00
Malaysia	3.25	3.25	3.50	3.75	3.75
India	6.75	6.50	6.25	6.25	6.25
Indonesia	7.00	7.00	7.00	7.00	6.75
China	4.10	3.85	3.85	3.85	3.60

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Asian FX ride the USD slide

- **Return of risk appetite has seen Asian currencies strengthen across the board but still lag DM currencies.**
- **We have adjusted our forecasts to take into account the changing environment.**
- **The rebound in the oil price seems to have stalled, Brent has retraced from highs of just below USD 42/bbl.**
- **China's new FX regime appears to be getting clearer, with the RMB Index appearing to be positively correlated with the DXY.**

The improvement in U.S. data and the stability in the price of oil and the RMB have combined to improve market confidence. This has sparked a rise in risk appetite and in turn boosted Asian currencies quite significantly.

We have tapered our USD/Asia FX forecasts for the coming quarters in view of the US Fed's dovish tilt – including lower 'dot plots' which offer further evidence of gradualism in the path of future policy normalization.

The rather moderate rebound in the price of oil has also served to calm markets without incurring fears of a contractionary impact. Oil prices appear to be in a "Goldilocks zone" that is contributing something to the recovery in risk appetite.

Also contributing to calmer markets is the apparent reduction in Chinese capital outflows together with a little more clarity on how the authorities intend to manage the RMB. The increased employment of fiscal policy has also contributed to a reduction in hard landing fears.

Asia's currencies lag

USD weakness has so far played out more against G10 currencies relative to Asian FX, although the latter has also seen quite a bit of strength. Within Asia, those currencies with a greater sensitivity to global moves, like the KRW and SGD, have been amongst the bigger beneficiaries in March. The MYR has also benefitted from the rebound in oil and some asset sales by a troubled state investment firm. The MYR's 6.6% appreciation against the USD could though prove fragile given that increased political risk does not yet appear to have been priced in.

A retracement in oil could also leave the MYR somewhat vulnerable, as too the IDR. For now though, Brent crude appears to be in a "Goldilocks zone" for Asian FX. The price of oil around current levels will still be supportive for most Asian economies, which are net oil importers, and the relative stability in the price of oil will provide some support to the currencies of the two oil exporters Malaysia and Indonesia.

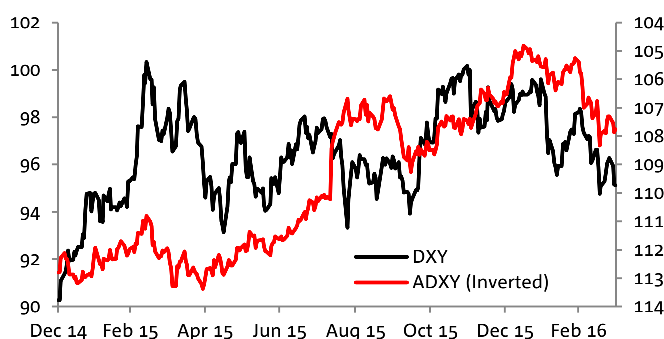
Asia's fundamentals remain little changed

Despite a more benign outlook for U.S. interest rates from the Federal Reserve, Asian central banks are not likely to cut policy rates more aggressively than previously projected. Overall, growth is likely to continue to moderate and policymakers are likely to attempt to support domestic growth engines but only India and Indonesia retaining significant room to ease monetary policy. Taiwan and Korea could both cut rates but neither has much room to ease aggressively.

We still expect the USD/CNY to trend higher, albeit at a more gradual pace than initially envisaged. Corporate demand to prepay foreign currency loans remains robust and the authorities are likely to allow that to dictate the overall direction over a multi-month time frame. Nevertheless, the move to manage the CNY against a basket of currencies, and in line with the overall USD movement, is proving somewhat successful in reducing excessive one-way bets on the USD/CNY.

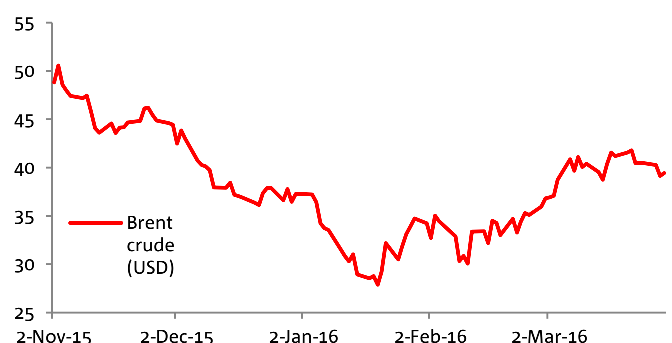
Hard landing fears should abate further, especially with the authorities committing to use fiscal policy more aggressively. The recovery in property prices in China may gain more traction while there are also emerging signs of more growth stability albeit at a slightly lower growth rate. The growth impetus from the service sector will be a strong cushion for overall GDP performance.

Chart 1: Asia's FX has lagged DM currencies



Source: NAB, Bloomberg

Chart 2: Rebound in the oil price petering out



Source: NAB, Bloomberg

China Spotlight: New FX regime still a bit of a "basket" case

- **The government's economic targets for 2016 through 2020 reflect an intention to persist with a managed slowing of the economy.**
- **The authorities appear to be allowing the RMB to depreciate against the CFETS Index against the backdrop of a weakening USD.**
- **The BIS has described the recent outflows as corporate debt prepayments; these appear to be continuing still.**

The balancing act continues

The key announcements from the National People's Congress (NPC) largely served to emphasize the government's commitment to reform in an organized manner. The main projections for 2016 have largely come in line with expectations and continue the trajectory of a gradual and controlled slowdown. Overall, this is the more responsible message to send out and the relative calm in the equity markets is probably in line with the tone of the NPC's targets.

The debate has now shifted to the authorities' threshold for near term economic pain and whether or not the slowdown can be managed. While both aspects will continue to be debated for some time to come, the nuanced stance by the authorities continues to strike a sufficiently good balance.

One aspect of that balance is the government's handling of the RMB. Thus far the authorities have maintained that they want to keep the RMB "basically stable" but recent actions suggest that the authorities are comfortable with a weaker RMB against the China Foreign Exchange Trading Systems (CFETS) basket of currencies. The CFETS is an agency under the PBoC and its main function is to provide systems that facilitate FX and derivatives trading, and RMB lending.

Slowing growth with targeted support

At the NPC, the growth rates in the key economic activity indicators of retail sales and fixed asset investment (FAI) were largely held steady relative to their 2015 growth rates at 11% and 10.5% respectively. The maintaining of the M2 growth rate at 13% and the modest increase in the fiscal deficit to 3.0% (from 2.3% in 2015) are in line with the targeted stimulus that has been applied over the last 18 months or so, in addition to shifting a greater share of the burden to fiscal policy from its erstwhile reliance on monetary policy. The government's projection of a modest increase in the unemployment rate from 4.05% currently to 4.5% is recognition of the fact that the slowdown will necessarily have some spill-over onto employment.

Managing the RMB against a basket

One thing to have emerged very clearly out of both the G20 meeting and the NPC is that RMB policy is now being carried out with respect to the basket of currencies as defined by the CFETS, rather than the bilateral USD/CNY rate.

PBoC governor Zhou Xiaochuan's acknowledgement that the RMB cannot be considered as "completely free floating" seems like a statement of the obvious, but it is perhaps also a hint that the authorities are still inclined to guide the RMB, and this adds a bit of colour to the erstwhile official characterization of "basically stable".

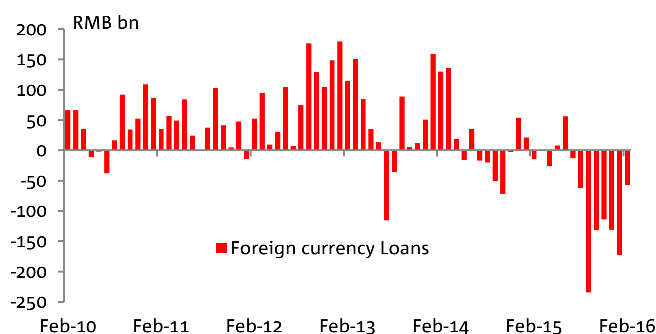
Since the start of the year, the CFETS RMB Index has fallen from 100.89 to 99.61 at the start of March to 98.05 on 18 March, with the rate of decline having increased significantly. At this juncture it is still unclear whether the authorities are managing the RMB Index on a downward trajectory or whether it is being guided to a lower level where it will be kept fairly flat. At the moment, the indications are that the latter scenario is more likely.

It is also possible that the authorities might have adopted an asymmetric reaction function, whereby the RMB Index is allowed to drift lower during risk-on periods where the broad USD is declining. However, during the risk-off/strong-USD periods, the RMB Index might be held stable or even allowed to creep up. This would help to reduce the likelihood of the "devaluation" narrative re-emerging and undermining broader market confidence.

Gradual upward drift in the USD/CNY

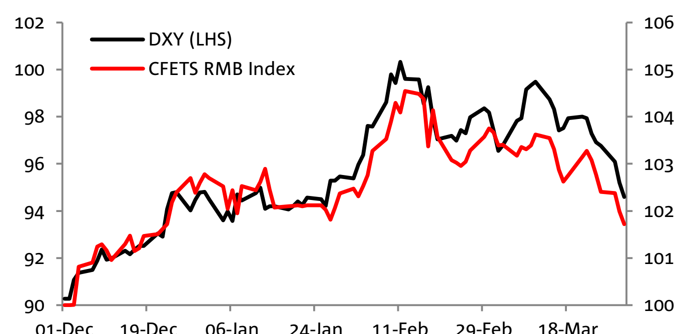
As such, the bilateral rate is probably likely to drift in line with the broad USD trend. However, current data and market feedback suggests that corporations are still very keen to pre-pay existing foreign currency debt and this will likely push the USD/CNY gradually higher over much of 2016 before the pair plateaus late in the year. In line with the more benign USD trend globally however, the USD/CNY will probably peak at a lower 6.65 around the end of 2016 before beginning a gradual decline through 2017.

Chart 3: Foreign currency loan deleveraging continues



Source: NAB, CEIC

Chart 4: RMB Index guided in line with DXY



Source: NAB, CEIC

Korea Spotlight: Feeling vulnerable

- **Downward growth revision and non-unanimous policy rate decision in March suggests that the recent recovery in KRW is fragile.**
- **The KRW may resume its underperformance relative to other regional currencies should external headwinds blow harder.**
- **A more stable CNY can provide some buffer along the way.**

The KRW has more than recovered its losses against the USD this year, some of the renewed strength attributed to the Fed's dovish stance and the reduction of its median 'dot point' forecast to 1.875% by end 2017, down from 2.375% forecast in December. The move in KRW was largely in line with regional currencies, with little change in the overall fundamental picture.

The KRW's underperformance against the JPY has consequently reduced, the JPY/KRW cross decline from a peak of 11.0 in February to 10.44 at time of writing.

The Bank of Korea held the base rate unchanged at 1.5% in March, but the decision was not unanimous, with one member of the MPC voting for a rate cut for the second month in a row. The risk of a cut increases after the Fed's dovish language and underpinned by the trend decline in exports and the weakening recovery in Korean domestic demand.

Growth revision underway

Despite a rather robust Q4 GDP performance at 3% yoy, the BoK recently commented that it may revise its 2016 GDP growth forecast down, to 2% from 3%. This would add to bearish sentiment in financial markets as the BoK has only just revised its GDP estimate lower from 3.2% in January.

Evidently, the drag from poor external sector performance looks set to persist, with January-February export growth having contracted 15.5% yoy on average. The Trade Ministry is expecting only a modest recovery in export growth to 2% this year from -8% last year.

The sluggishness of domestic demand is reflected in a slump in imports - down 17.3% for the first two months of 2016.

A recent BoK report revealed a narrowing gap in the competitiveness between South Korean and Chinese products, highlighting the loss in Korea's competitiveness. The BoK's Revealed Comparative Advantage (RCA) of South Korean semiconductors only inched up to 3.39 points in 2013 from 3.13 in 2005 while that of Chinese semiconductors surged to 1.60 from 0.70 over the cited period. The RCA of South Korea's entire electronics sector slipped to 1.79 points from 1.85 points over the 2005-2013 period while that of China advanced to 2.11 points from 1.88 points. The report concluded that South Korea needs to continue maintaining the competitiveness of its key products in China while realigning its economic structure to better complement that of China and thus utilizing China's future economic development as an opportunity for growth of its own.

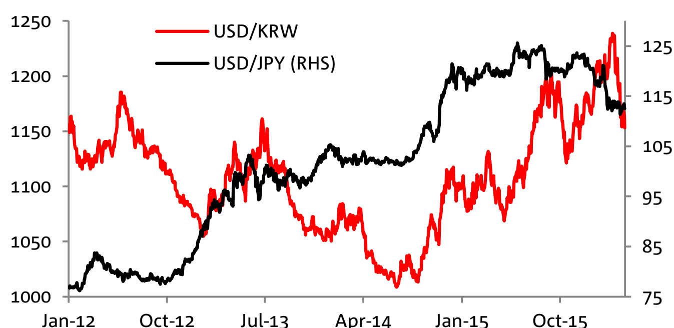
Rebound in oil prices poses limited risk to inflation

The rebound in oil prices may drive inflation higher, but at this juncture is still posing very little risk. The spike in CPI in February from 0.8% in January to 1.3% was largely due to increases in agricultural product prices. Core inflation excluding agricultural and petroleum product prices meanwhile rose slightly to 1.8%, from 1.7% in January. Risks are now to the upside should oil prices continue to recover from here and further spikes in inflation may narrow the BoK's window to implement a rate cut in the near term.

KRW strength could be fragile

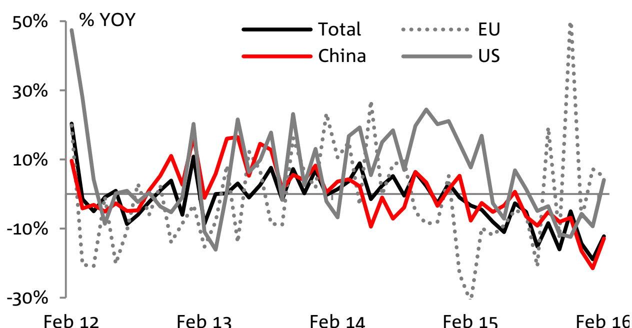
The argument for a weaker KRW ahead prevails in the form of a weak external sector outlook, loss in product competitiveness as well as subdued inflation risks.
The stability in USD/CNY movements recently is arguably comforting, but China's intention to guide the CNY lower on a trade-weighted basis is unlikely to go unnoticed.
The broad USD environment has weakened visibly so in that regard we deem it fit to revise USD/KRW forecast lower to 1220 from 1250 for end-2016.

Chart 5: KRW strengthened against the JPY from mid-Feb



Source: NAB, CEIC

Chart 6: Exports bottoming but still weak



Source: NAB, CEIC

India Spotlight:
INR to drift amidst GST limbo

- **The government's FY2016 budget has maintained its commitment to fiscal discipline but growth remains a slight worry.**
- **The GST bill remains stalled in the upper house and chances of passage this year are falling.**
- **The RBI remains rather watchful over the USD/INR and has the wherewithal to restrict excessive movement on either side.**

The USD/INR continues to drift with the overall USD tide, with the Reserve bank of India (RBI) and the stronger balance of payments fundamentals helping to cushion the movements on either side. Momentum for the USD/INR will likely remain limited ahead of the results of the upper house elections in April, which could determine whether or not the government manages to pass its Goods & Services Tax (GST) bill in the next few months.

In the meantime, the economy appears to be mostly sustained by consumption, with the investment growth engine spluttering noticeably. It is quite possible that the RBI will bring forward its rate cuts, even as it awaits the government's budget to assess the amount of stimulus in the economy.

As growth cruises along, the USD/INR should remain fairly stable. Part of the reason for this will of course be the RBI intervening on both sides. Additionally, the wide positive carry will support the INR, but the small current account deficit will limit the scope for rapid appreciation. A fairly stable oil price will also help to reduce the depreciation pressure on the INR.

Flagging investment could prompt early RBI action

Industrial production data continues to point to consumption remaining fairly resilient but investment continues to decelerate. Granted, the RBI might not be too worried given that its own Industrial Outlook Survey suggests that the industrial sector is not that downcast, at least in terms of the evaluation of the current situation.

Most relevant are the sub-components that pertain to the financial situation and these suggest financing is not a problem at the moment.

Inflation continues to ebb, but slowly. Food, which accounts for close to half of the CPI basket, is likely to see a low-base effect till around June. This is another reason for the RBI to hold off on its rate cuts till the second half of 2016.

Two more cuts remain likely this year but the probability of the RBI front loading these rate cuts remains finely poised. NAB India economist John Sharma expects one cut in April followed by another in September.

Upper house elections - a small window of opportunity

Increasingly, the passage of the GST bill in H1 2016 looks unlikely, despite the first round of elections in the upper house (Rajya Sabha). Only a limited number of seats are up for renewal and there is unlikely to be a sufficient shift in the representation there to give the government the two thirds majority it needs to get the GST bill passed at the Federal level.

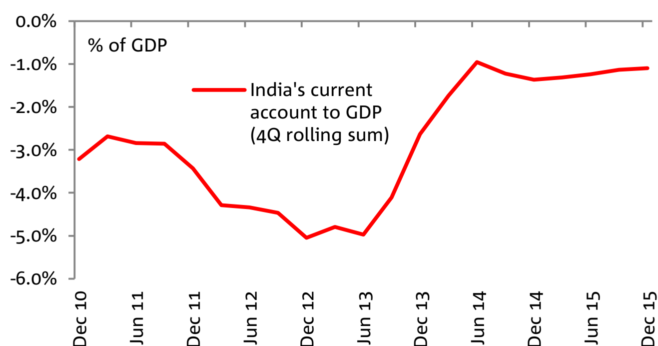
The passage of the GST bill this budget session was always more of a positive surprise, rather than something that has been priced in. There is thus unlikely to be significant damage to sentiment from a delay in the passage of the GST bill.

RBI to keep the USD/INR volatility contained

Amongst the various bilateral Asian FX rates, the USD/INR is likely to come out as one of the more stable pairs. The INR still has a rather robust carry, and a fairly interventionist central bank, on its side. Structurally, the rather slim current account deficit of just 1% of GDP will allow portfolio inflows to have a greater impact on the INR. The RBI will probably act to smooth out any surge in inflows, but it is unlikely to stall appreciation altogether.

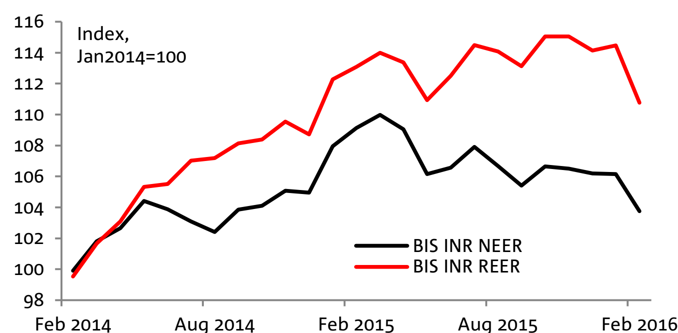
Further out, when India's inflation starts to moderate in H2, and if US inflation continues to edge higher, the gap between the INR NEER and REER should start to narrow and allow the INR to gain competitiveness even as it appreciates in nominal terms.

Chart 7: Current account helps stabilise INR



Source: NAB, CEIC

Chart 8: Falling inflation improves competitiveness



Source: NAB, CEIC

Singapore Spotlight: Time to get fiscal

- **The FY2016 budget is fairly expansionary despite the overall surplus and reduces the need for monetary stimulus.**
- **The NEER is around the mid-point of the policy band so there is little pressure to shift the boundaries of the band.**
- **However, expectations are still for a further slowing of the economy and the authorities still perceive a negative output gap so easing in October is still possible.**

The balance of factors are lining up in support of a no-change position from the Monetary Authority of Singapore (MAS) when it meets in the second week of April for its six-monthly monetary policy meeting. However, an easing in October should not be ruled out given expectations of further slowing in the economy and the perception of current growth as being below trend.

The government budget for FY2016 has turned out to be surprisingly expansionary despite the headline number swinging from a planned deficit in FY2015 to a planned surplus. The government is actually planning to widen the primary deficit to 1.2% of GDP from an actual FY2015 deficit of 1.1%. This is however obscured by a one-off increase in the net investment returns and a reduction in some government transfers.

Further out though, the private sector is still somewhat bearish on growth. The March 2016 MAS survey of professional forecasters has expected growth for 2016 falling from 2.2% to 1.9%, and inflation expectations also weakening.

Fiscal spending continues to remain strong

Against expectations of a more cautious budget, what was announced turned out to be fairly ambitious. As a share of GDP, total expenditure is projected to rise to 17.9% in FY2016 from 17% in FY2015. This is significantly higher than the 2010-2014 average of 13.7%, with both operating and development expenditure contributing to the increase.

FY2015's increase was largely in the area of transportation, with expansion plans for both the airport and the Mass Rapid Transit (MRT) accounting for much of the increase in spending. FY2016's spending increase at the margin was more in healthcare and security, perhaps reflecting the recent risks of MERS and terror threats. Nevertheless, spending on transport infrastructure remains close to FY2015 levels.

The primary deficit is to be funded by increased net returns from (largely overseas) investments that push the overall fiscal balance into a surplus. The government is net creditor so there is no concern on the fiscal front.

Little need to adjust policy band trajectory

NAB estimates that the S$NEER is just recently risen slightly above the mid-point of the policy band so there is little need to adjust the band to adjust for potential market movement. While the FX market could see some volatility over the next few months, overall USD strength is likely to return only at a gradual pace, as the interest rate normalization proceeds at a very measured pace. With the CNY also likely to weaken gradually, the current policy band trajectory is likely to still have enough downside room to accommodate any downward move in the S$NEER.

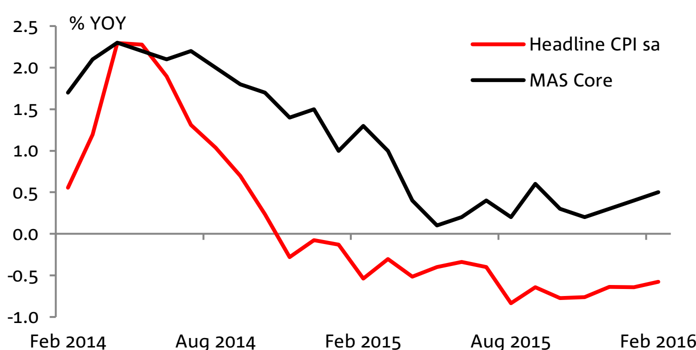
Inflation, at least as measured by the MAS Core CPI, looks to have bottomed decisively and has been climbing very gradually. Low-base effects should kick in in Q2 2016 and persist into July and August, which could cause inflation expectations to climb somewhat.

Monetary loosening still in the frame

The March 2016 MAS survey is likely to keep a loosening move in October still in the frame of discussion.
The expectations for weaker 2016 growth were largely predicated on slowing in manufacturing and finance, but expectations regarding domestic consumption growth have improved. The sharp slide in expected growth for the financial sector might worry MAS somewhat, although it is questionable whether the S$NEER is the appropriate policy tool for that sector.

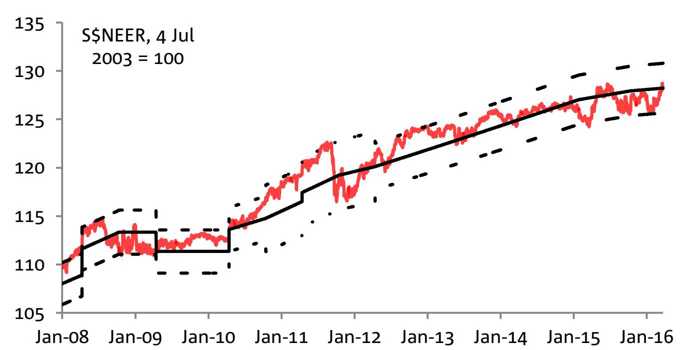
The authorities see the output gap (current growth minus potential) dipping very slightly into negative territory this year. Any significant underperformance of the 1%-3% growth outlook could therefore see MAS employ monetary stimulus. For the near term, policy developments should be SGD-supportive, but this could well change later in the year.

Chart 9: Core CPI continues to climb gradually



Source: NAB, CEIC

Chart 10: S$NEER currently at the middle of the policy band



Source: NAB, CEIC

Selected Indicators

Table 1: NAB Asian FX Forecasts

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
USD/CNY	6.49	6.55	6.60	6.65	6.60	6.55	6.55	6.50
USD/IDR	13368	13500	13600	13700	13700	13600	13500	13300
USD/INR	66.6	67.5	67.0	67.0	66.0	65.0	64.0	63.0
USD/KRW	1162	1175	1190	1220	1200	1200	1180	1150
USD/MYR	4.00	4.30	4.35	4.40	4.40	4.40	4.38	4.35
USD/PHP	46.3	46.8	47.0	47.2	47.0	46.6	46.2	46.0
USD/SGD	1.37	1.38	1.39	1.40	1.39	1.38	1.38	1.37
USD/THB	35.4	36.0	36.5	37.0	37.0	37.5	37.5	37.5
USD/TWD	32.6	33.0	33.2	33.5	33.5	33.2	33.0	32.7

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
AUD/CNY	4.67	4.85	4.69	4.59	4.55	4.59	4.72	4.75
AUD/IDR	9625	9990	9656	9453	9453	9520	9720	9709
AUD/INR	47.9	50.0	47.6	46.2	45.5	45.5	46.1	46.0
AUD/KRW	837	870	845	842	828	840	850	840
AUD/MYR	2.88	3.18	3.09	3.04	3.04	3.08	3.15	3.18
AUD/PHP	33.3	34.6	33.4	32.6	32.4	32.6	33.3	33.6
AUD/SGD	0.99	1.02	0.99	0.97	0.96	0.97	0.99	1.00
AUD/THB	25.46	26.64	25.92	25.53	25.53	26.25	27.00	27.38
AUD/TWD	23.48	24.42	23.57	23.12	23.12	23.24	23.76	23.87

Table 2: NAB Key FX Forecasts

		Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Australian Dollar	AUD/USD	0.72	0.74	0.71	0.69	0.69	0.70	0.72	0.73
New Zealand Dollar	NZD/USD	0.65	0.65	0.63	0.61	0.61	0.62	0.63	0.65
Japanese yen	USD/JPY	115	115	115	117	118	120	120	119
Euro	EUR/USD	1.09	1.12	1.11	1.09	1.09	1.09	1.10	1.10
British Pound	GBP/USD	1.35	1.43	1.44	1.43	1.43	1.44	1.44	1.45
Swiss Franc	USD/CHF	1.00	0.98	1.00	1.04	1.05	1.05	1.04	1.05
Canadian Dollar	USD/CAD	1.34	1.34	1.39	1.45	1.44	1.43	1.41	1.40
Chinese New Yuan	USD/CNY	6.60	6.55	6.60	6.65	6.60	6.55	6.55	6.50

Table 3: NAB Asia Macro Forecasts

Average annual growth in GDP (%)	2013	2014	2015	2016	2017
Hong Kong	3.1	2.5	2.5	2.6	2.6
Indonesia	5.6	5.0	4.8	4.5	4.5
Singapore	4.4	2.9	2.2	2.9	2.9
Taiwan	2.2	3.9	0.9	0.5	0.5
Thailand	2.7	0.8	2.8	3.8	3.8
Malaysia	4.7	6.0	6.1	4.3	4.3
S Korea	2.9	3.3	2.6	2.9	2.9
Philippines	7.1	6.1	5.8	5.7	5.7
Total	**4.2**	**4.1**	**3.6**	**3.5**	**3.5**
China	7.7	7.3	6.9	6.7	6.5
India	6.4	7.1	7.5	7.6	7.4

Table 4: NAB Key Macro Forecasts

Country/region	2011	2012	2013	2014	2015	2016	2017
United States	1.6	2.2	1.5	2.4	2.4	2.2	2.3
Japan	-0.4	1.7	1.6	-0.1	0.6	1.1	0.9
Euro-zone	1.7	-0.8	-0.2	0.9	1.4	1.7	1.9
United Kingdom	2.0	1.2	2.2	2.9	2.2	2.2	2.2
Emerging Asia	4.4	4.6	4.2	4.1	3.6	3.6	3.8
Latin America	4.9	2.5	2.6	0.9	-0.4	-0.3	1.2
China	9.3	7.8	7.7	7.3	6.9	6.7	6.5
Canada	3.0	1.9	2.0	2.5	1.2	1.7	2.0
Australia	2.7	3.5	2.0	2.6	2.3	2.7	3.0
New Zealand	1.8	2.4	2.3	3.3	2.2	1.8	2.0
India	7.9	4.9	6.4	7.1	7.5	7.6	7.4
Africa	5.4	4.4	5.2	5.0	3.5	4.0	4.0
Eastern Europe	5.4	1.4	2.9	2.8	3.0	2.9	2.6
Middle East	3.9	4.8	2.4	2.8	2.5	2.5	2.5
Other advanced	3.3	2.0	2.2	2.8	2.3	2.4	2.6
World	**4.39**	**3.38**	**3.27**	**3.32**	**2.92**	**3.02**	**3.27**

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