18 April 2019 Global

FX AND RATES

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Global FX Outlook

The 'Top is in' for the US Dollar

In Q1, the Fed's about-face on extending its rate-hiking cycle, its "flattened dots" in March, its decision to wind down quantitative tightening, and the backdrop of slower US growth in Q1 had many analysts calling (again) for the "death of the dollar" on its debasement. **Yet "bad news" for the USD was more than equalled by the bad news for other currencies – especially the EUR, the CAD, and the AUD.** Their central banks also turned 'dovish' in Q1, at least in rhetoric, if not in practice, as fear of a slowdown in the home economies emerged. Knowing that this "call and response" between the Fed and other central banks was in effect, we stuck to our strong & steady view of the USD throughout Q1, secure in the knowledge that the US economy would emerge from its own soft patch before others did.

But as we go into Q2, we now see imminent downside risks for the USD building, as global growth is seen to have started a tentative recovery from its 3-quarter slump. Stimulus from China, a wind-down of the 'trade wars', and calmer seas on the European political front are all developments that could entice some risk-taking into heretofore more fragile economies, even if the 'carry' in those currencies remains inferior to the USD's. The EUR could be the greatest beneficiary of this turnaround, (our year-end projection is 1.17) given the dependence of its industrial economy (which has suffered the most), but the AUD and NZD could also benefit, as could the GBP. Our year-end projection for the AUD/USD is 0.72, and 1.34 for the GBP/USD. Within the developed markets, we remain bearish only on the CAD, where the Canadian household's idiosyncratic issues will plague the loonie's prospects, and we project the USD/CAD to be at 1.38 at year-end.

In the EMs, risks are skewed towards further CNY appreciation as the US and China inch towards extending their fragile trade truce, including an agreement to preclude CNY devaluations. Should these things transpire, the CNY would be at the core of a broad rally in sentiment for Asia's currencies. So we see room for the KRW and TWD to reverse their Q1 underperformance rallies alongside CNY strength. The SGD is also likely to do well with broad USD weakness in the region, and continued modest NEER outperformance. However, we have pared back our enthusiasm for the high yielders – the IDR, etc.

In Latin America, a weaker USD could help currencies outside the USD bloc, such as the BRL and ARS. But these currencies will more likely continue to be driven by local events – i.e., whether the pension reform passes in Brazil, and whether tight monetary policy succeeds in controlling inflation in Argentina without adverse political ramifications. **Mexico is in the USD bloc, and won't benefit as much from a weak USD. Indeed, a repetition of the volatility of 2016 looms with the coming US election of 2020. The MXN's vols, interestingly, are low.**

In emerging EMEA, politics dominates, especially in Turkey, where an adverse backdrop risks flight into USD deposits, putting pressure on the TRY. **Although not without its own risks, we are more comfortable with the RUB, especially insofar as Russia's healthy external accounts, low government debt, and substantial FX reserves make it stand out against Turkey.** We see South Africa's ZAR as an important beneficiary of an EM FX rally, too, supported by the rating agencies' forbearance.

Strategists

Macquarie Futures USA LLC

Thierry Wizman +1 212 231 2082
thierry.wizman@macquarie.com

Macquarie Bank Limited Singapore Branch

Gareth Berry +65 6601 0348
gareth.berry@macquarie.com

Macquarie Bank Limited Hong Kong Branch

Trang Thuy Le +852 3922 2113
trang.thuyle@macquarie.com

Macquarie Capital (Europe) Limited

Eimear Daly +44 20 3037 4802
eimear.daly@macquarie.com

Macquarie Securities (Australia) Limited

Ric Deverell +61 2 8232 4307
ric.deverell@macquarie.com

Hayden Skilling, CFA +61 2 8232 2623
hayden.skilling@macquarie.com

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Forecast Summary

Fig 1 Major currency FX forecasts summary

Currency	vs.	Spot Latest	Forecasts* 19Q2	Forecasts* 19Q4	Near-term view
US dollar	EUR	1.131	1.150	1.170	**Increasingly Bearish.** Factors that kept the USD strong in Q1 - the global industrial slowdown and ongoing political tensions abroad – are in the process of reversing. This should underpin weakness in the USD in Q2 and H2 2019, at least against those currencies that *had been* hurt the most from the aforementioned conditions – e.g., the EUR and AUD. The end of the Fed's QT, alongside the prospect of a symmetric inflation target, make loose monetary policies abroad more moot.
by market convention	JPY	112.0	113.0	110.0	
	GBP	1.304	1.320	1.340	
	AUD	0.720	0.710	0.720	
	CNY	6.69	6.65	6.60	
Euro	USD	1.131	1.150	1.170	**Upside ahead.** An economy so dependent on the external growth environment looks set to benefit from the sudden turnaround in China data, and the tantilising prospect of a US-China trade deal being finalised over the coming months. Brexit has been defused (for a while at least) which should help safeguard manufacturing supply chains for now. It's hard to imagine Draghi's successor (from November onwards) being more dovish than he has been.
Foreign currency units per euro	JPY	126.7	130.0	128.7	
	GBP	0.867	0.871	0.873	
	AUD	1.571	1.620	1.625	
	CNY	7.56	7.65	7.72	
Japanese yen	USD	112.0	113.0	110.0	**Bearish now, but bullish longer-term.** Japanese investors are still selling yen aggressively, and we wouldn't want to stand in their way. Structural bulls will need patience, but should eventually be rewarded. In the meantime, a revival in global risk appetite coupled with a low vol environment argues for mild further weakness.
Yen per unit of foreign currency	EUR	126.7	130.0	128.7	
	GBP	146.1	149.2	147.4	
	AUD	80.7	80.2	79.2	
	CNY	16.7	17.0	16.7	
	USD	112.0	113.0	110.0	
UK sterling	USD	1.304	1.320	1.340	**Bullish.** It's increasingly clear than neither the UK nor the EU want a hard no-deal Brexit. Two cliff-edges have been avoided so far and although a new Brexit deadline of Oct 31st has been set, that can be pushed back too if the UK needs more time to reconsider the wisdom of EU exit. Upcoming EU parliamentary elections should help the UK keep one foot in the door, and we doubt PM May's successor will take Brexit policy in a much more confrontational direction.
Foreign currency units per pound	EUR	1.153	1.148	1.145	
	JPY	146.1	149.2	147.4	
	AUD	1.811	1.859	1.861	
	CNY	8.72	8.78	8.84	
Australian dollar	USD	0.720	0.710	0.720	**Neutral, with slight upside drift.** Downside risks are present, but 70c is likely to act as a major support, in the absence of a major global shock. The rates market has already priced in at least one RBA cut by year-end, and underlying flows arising from Australia's monster trade surplus should help AUD inch higher over time, aided and abetted by the high iron ore price. EUR and CNY strength against USD this year should lend some additional support indirectly, once the upcoming federal election on May 18th is out of the way.
Foreign currency units per dollar	EUR	0.637	0.617	0.615	
	JPY	80.7	80.2	79.2	
	GBP	0.552	0.538	0.537	
	CNY	4.82	4.72	4.75	
Chinese renminbi	USD	6.71	6.65	6.60	**Bullish.** Solid recovery in China economic momentum combined with the prospect of a near term US-China trade deal leads us to expect yuan to lead Asia FX recovery. An overshoot to 6.50 is possible, although we think anything beyond may see PBoC withdraw last year FX stabilization measures such as the Counter Cyclical Adjustment Factor or reserves on FX forwards.
RMB per unit of foreign currency	EUR	7.55	7.65	7.72	
	JPY	0.060	0.059	0.060	
	GBP	8.72	8.78	8.84	
	AUD	4.80	4.72	4.75	

Source: Bloomberg, Macquarie Strategy. *End-of-quarter forecasts.

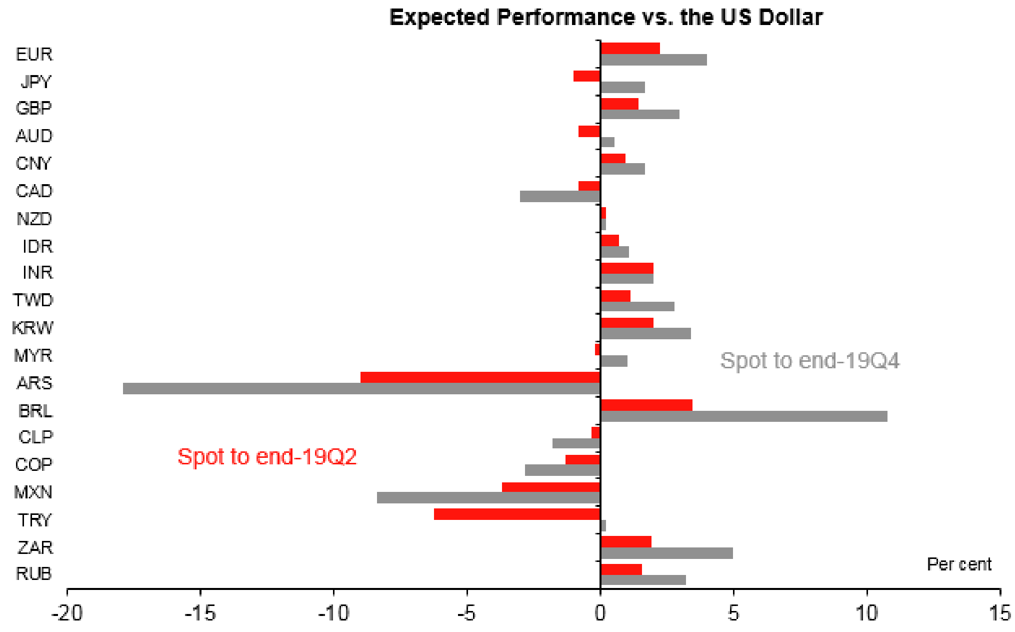
Fig 2 Other currency FX forecasts summary*

Currency	vs.	Spot	Forecasts**		Near-term view
		Latest	19Q2	19Q4	**Near-term view**
Canadian dollar	USD	1.334	1.35	1.38	**Bearish.** The Loonie weakens in 2019, as debt-burdened consumers retrench, and the BoC is inclined to continue to lower its neutral rate of interest estimate, leading to a peak in the policy rate that is much lower than in the US, to the disadvantage of the CAD.
New Zealand dollar†	0.674	0.67	0.67	0.674	**Neutral.** NZD is likely to continue to shadow AUD over the coming months. The immediate FX outlook will be determined by when the RBNZ acts on its new explicit easing bias, and the local dataflow (which has been healthy) may not be the only consideration here.
Indonesian rupiah	USD	14045	13950	13900	**Neutral.** Global backdrop has become less supportive with rising oil prices and global bond yields. Inflows into Indo government bonds are unlikely to be repeated with government already front-loaded issuance (~40% in 1Q). The wider trade deficit and Jokowi's infrastructure push could get investors more nervous, especially if prospect of Fed normalization returns in 2H.
Indian rupee	USD	69.6	68.0	68.0	**Neutral.** A good election outcome will still drive a 1%-2% INR rally. But higher oil prices, rising global yields, and seasonal deterioration in the India current account position suggest a more challenging backdrop afterward. Concerns on Fed policy normalization may return to weigh on deficit EM countries in 2H.
Taiwan dollar	USD	30.8	30.5	30.0	**Moderately Bullish.** Vols have been suppressed but a change in government policy to encourage business repatriation combined with a pickup in global trade will likely drive TWD gains.
Korean won	USD	1135	1115	1100	**Bullish.** A recovery in global trade and a seasonal rebound in Korea's current account position in 2Q should see exporters return to sell USD. Investors into Korea were hedging won exposure so far but could reduce their hedges as prospect for won improves. A dovish BoK and the possibility of a May rate cut may still weigh on the won near term, but prospect should improve after.
Malaysian ringgit	USD	4.14	4.15	4.10	**Underperform.** Concerns on foreign bond outflows will likely lead to ringgit underperformance. Foreign investors hold 38.7% of Malaysia. FTSE Russell review and the broader trend of China inclusion in major global bond indices will likely dilute the weight for Malaysia bonds. Higher oil prices and a recovery in global trade will help mitigate some of the negative impacts from bond outflows.
Argentinian peso	USD	41.9	46.0	51.0	**Bullish, when accounting for carry.** With its IMF program, Argentina should make slow but steady adjustment towards a sustainable BoP and fiscal responsibility. Monetary policy anchored by a stable monetary base will help reduce inflation. We expect Macri to win the election in 2019, extending a market-friendly outlook.
Brazilian real	USD	3.93	3.80	3.55	**Bullish.** A supply-side oriented economic policy agenda, if fully implemented, would mark a radical shift in for the economy, associated with better trend growth and a reduction in country risk as debt dynamics stabilize. Political uncertainty will present as volatility, but H2 should see uncertainty fade. .

Currency	vs.	Spot Latest	Forecasts** 19Q2	19Q4	Near-term view
Chilean peso	USD	661	665	675	**Neutral.** The resumption of global growth will help the copper exporter's terms of trade. But with low interest rates locally and higher yields abroad, traders won't flock to the CLP. The BCCh will stay 'dovish' (and possibly cut rates) with the low inflation revealed by the CPI basket revisions and with the suppression of wages due to in-migration.
Colombian peso	USD	3158	3200	3250	**Neutral.** It will take a while to convince investors that Colombia will get its fiscal house in order, but this should happen eventually on forthcoming reforms. We don't expect a rating downgrade in 2019. In the meantime, firm oil prices should ensure that the trade balance doesn't erode, and that short-term fiscal targets are met.
Mexican peso	USD	18.85	19.75	20.50	**Bearish, although partly compensated by carry.** In reversing prior reforms, the new administration may alienate FDI, which may decline to pre-NAFTA levels. Timely passage of the new NAFTA is also now in doubt, and the forthcoming election season in the US poses risks.
Turkish lira	USD	5.75	6.20	5.8	**Bearish.** Market focus on the erosion of Turkey's democracy and US sanctions risk lead to foreign investor outflow from Turkish assets. Domestic demand for USD deposits is also adding to downside pressure on TRY
South African rand	USD	14.02	13.8	13.4	**Bullish.** Credible central bank policy, significant FX reserves, healthy external balances and receding domestic risks suggest ZAR should benefit from an increasingly positive environment for EM assets.
Russian ruble	USD	64.1	63.0	62.0	**Bullish.** Positive external balances, falling government and real economy debt, limited FX exposure and significant FX reserves means RUB assets will remain favourable in the current EM positive environment. However, stretched positioning will limit RUB upside and politics remains a risk

Source: Bloomberg, Macquarie Strategy. *Currencies are quoted as domestic currency per US dollar unless otherwise specified († denotes inverse quotation). **End-of-quarter forecasts.

Fig 3 The major crosses are likely to diverge significantly in coming months…



Source: Bloomberg, Macquarie Strategy.

Thierry Wizman
+1 212 231 2082
thierry.wizman@macquarie.com

The US Dollar: The Turning Point Arrives

Q1 of 2019 saw the USD generally strengthen against its key DM peers. Yet some events and trends were *not supposed* to be good for the USD; the Fed's about-face on extending its rate-hiking cycle, its decision to wind down quantitative tightening, and the backdrop of slower US growth in Q1 had many analysts calling (again) for the "death of the dollar". But bad news for the USD was more than equalled by the bad news for other currencies – especially the EUR, the CAD, and the AUD. Their respective central banks also turned 'dovish' in Q1, and growth in their respective home economies slowed dramatically in Q1 too. Knowing that this "call and response" between the Fed and other central banks was in effect, traders hardly sold the USD when the FOMC flattened its 'dots' at its March meeting. Indeed, concerns about the prospect of slow growth globally only reinforced a strong USD story in Q1, as the typical flight to safety continued to prevail. **Anticipating this, we stuck to our strong/steady USD view in Q1.**

But as we go into Q2, we see downside risks for the USD building, as global growth is seen to have started a tentative recovery from its 3-quarter slump. That's a development that could entice some risk-taking into heretofore more fragile currencies, even if the 'carry' in those currencies remains inferior to the USD's. **Looking at just the US data released since the end of Q1 reveals a bias toward the "recovery side" than the "recession side" of the Q1 outlook.**

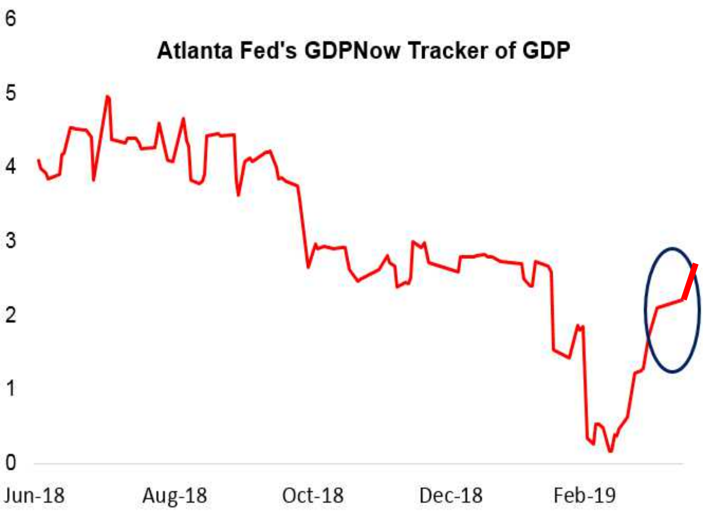
- A healthy 196k rebound in non-farm payrolls in March put the Q1 average at a still-strong 180k after a 233k monthly average in 2018.
- There was also sturdy set of ISM surveys in March, led by the New Orders sub-indexes.
- We further note that a surge in US March light vehicle sales (17.5mn units sold vs 16.6mn in Feb) put March sales above the 12-month moving average (Fig. 5).
- And even a downbeat February US retail sales print wasn't too bad after taking into account revisions. March, of course, saw a strong recovery with and without autos.

From this, the US consumer may have been shaken by the government shutdown, but hardly knocked out. As for business spending, the durable goods orders report showed that non-defense capital goods shipments excluding aircraft was running at growth of 4.5% annualized, vs. Q4 2018 average.

So even *if* the US still saw a serious soft patch in late Q4 and early Q1, that soft patch is likelier to result in real GDP growth of at least 1.5% in Q1, rather than the near-1% growth that analysts had feared early in the quarter. To wit, the Atlanta Fed's GDPNow estimate has jumped back up to near 2.8% as of mid-April (Fig. 4) and the New York Fed's NowCast estimate of Q2 growth also exceeds 2%, but subject to *upward* revision. Other observers have made the point that with the unresolved seasonal adjustment issues that have plagued Q1 data processing for several years, "actual" Q1 growth is somewhat stronger than what the professional forecasters are predicting *and* what the BEA is expected to report".[1]

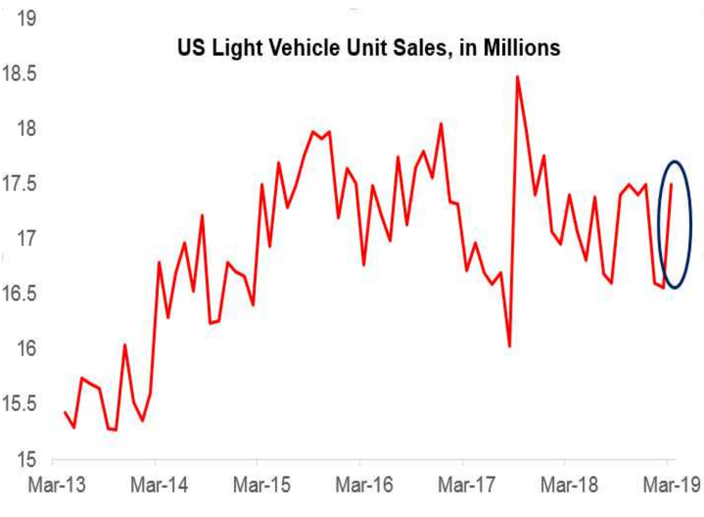
[1] See Glenn D. Rudebusch, "The Puzzle of Weak First-Quarter GDP Growth", and "Here We Go Again: Weak Growth to Start the Year", Federal Reserve Bank of San Francisco (here and here). Rudebusch estimates that a 0.4%-0.6% (annualized) downward bias may still exist in the Q1 GDP estimates of the Bureau of Economic Analysis.

Fig 4 GDP trackers have bounced



Source: Bloomberg, Macquarie Strategy

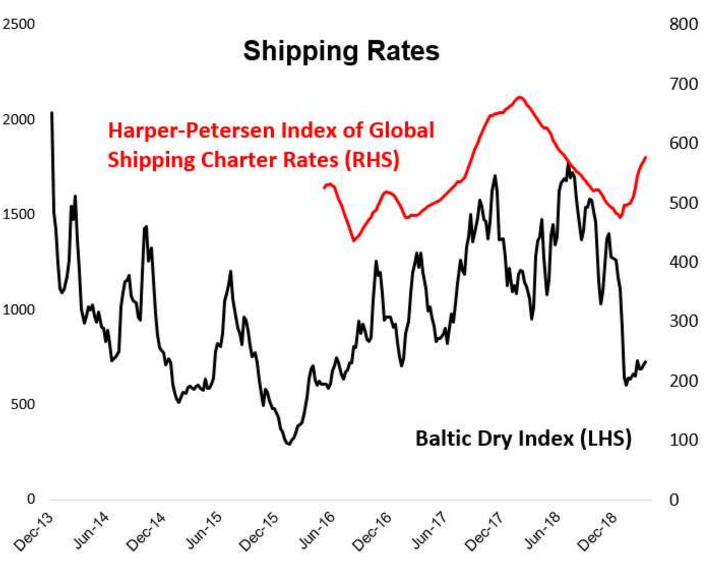
Fig 5 Vehicle sales reflect strength of consumer



Source: Bloomberg, Macquarie Strategy

And *outside* the US, we've also seen better indicators in April. The jump in the China March manufacturing PMI was matched by reports of ongoing strength in excavator sales in March, and growth in Total Social Financing in Q1 exceeded 10%, thanks to the healthy March figures. Then, the March data for GDP, fixed asset investment, and property sales surprised even more. In the Euro area, the services PMIs stayed robust in March, to the dismay of observers putting too much emphasis on industry. Euro area sentiment indicators in March, such as the Sentix index, rose to their highest level since November 2018 (albeit still negative). This was driven by an improvement in expectations, perhaps as investors were getting less worried about international trade and the outlook for China. Some price indexes are also corroborating the recovery story; the Baltic Dry Index and the Harper-Petersen Index of Global Shipping Rates have also troughed (Fig. 6).

Fig 6 Global Shipping Rates at Troughs



Source: Bloomberg, Macquarie Strategy

Fig 7 China Infrastructure on the Rebound

Source: Bloomberg, Macquarie Strategy

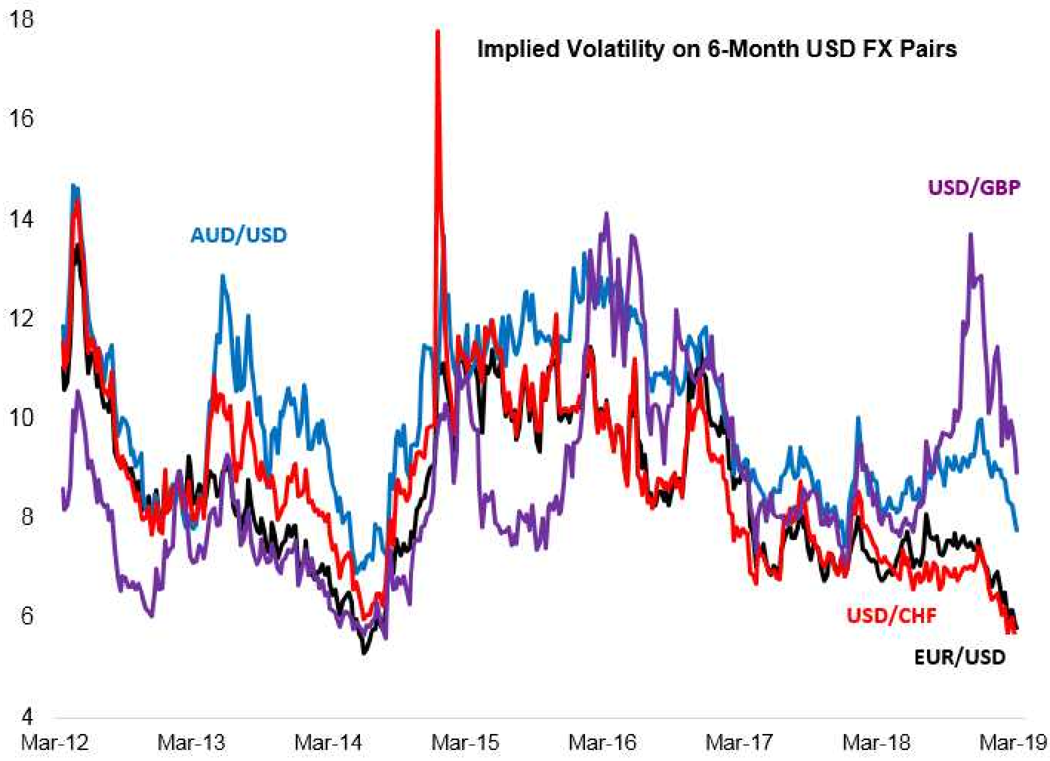
We've noted that the two prior post-GFC global "soft patches" (in 2012 and in 2016) lasted around 2-3 quarters, followed by recoveries, so a recovery from the late 2018-early 2019 soft patch is also 'due'. That recovery may be 'led' by the US and China, but we believe that traders will quickly infer the positive spill-overs for Europe.

And even if global growth may not be strong enough to spur a reversal of flight-to-safety, we highlight that some upcoming events could abet the trend away from the USD by mid-2019. The extension of the Brexit cliff-edge to June would result in clarity on the Brexit outlook by then, as would a resolution of the US-China trade war, even if *existing tariffs* are left in place. The political risk around the EU parliamentary elections should be out of the way by late May too, removing another source of uncertainty. **Indeed, we have felt since 2017 that political risk is higher in Europe than in the US. But after two years, European policy risk may be waning relative to the US, especially as the latter enters a 2020 election season that is apt to be fraught with rancor.** Thus, the issues surrounding Italy's dispute with the EU are unlikely to fade, but they may take a back-seat to the uncertainty posed by a Democratic re-capture of the White House or the Senate, in the US, in 2020.

What will DM central banks be doing in the context of a growth recovery in H2? For now, of course, both the Fed and the ECB seem happy to keep policy rates unchanged, and the ECB has even recently extended its "period of stasis" to the end of 2019. But should inflation perk up alongside a growth recovery, we would expect that the Fed would shift its rhetoric toward an asymmetric bias, and may act on that with *one more* Fed Funds rate target near the end of 2019. This may help limit the USD's weakness in late 2019, but the extent of the Fed's hawkishness would be limited by the prospect that the Fed's own comprehensive review would result in policymakers adopting a long-term symmetric interpretation of the 2% inflation target, and the knowledge that quantitative tightening is highly unlikely to resume once it ends in late 2019. Indeed, it is clear that the Fed is biasing its own policy toward the goal of *higher inflation*. (This is one reason to be long inflation breakevens, we would argue.) Indeed, in mid-March, Jay Powell called low inflation "one of the major challenges of our time", lamenting how the Fed is 'paddling upstream' when inflation break-evens are sub-2%. **The Fed itself, therefore, is likely to accommodate a weaker USD, with some political support from the administration, should it need it.** On the other hand, at the ECB, the identity of President Mario Draghi's successor should be made known in July, an event that may increase speculation about the timing of the ECB's first rate hike. **The Bottom Line is that we doubt that the Fed will focus on tamping down on inflation pre-emptively, and even if they do so by year-end, a single rate hike is unlikely to be enough to overcome the willingness of traders, fixed income managers, and reserve asset managers to start to raise exposure to the EUR, GBP, AUD, and NZD.**

And as we consider how to play this 6-9 month view on the USD, we are captivated by how low option premium in the various USD pairs has fallen in Q1. Volatility on six-month EUR/USD call options, for example, is at 5.8%, the lowest level since 2014, just before the ECB began its bona fide quantitative easing. Vols on AUD/USD are also near 5-year lows, at 7.8%. At 5.5%, vols on USD/CHF optionality is at all-time lows. **So if there is a time to buy "gamma" on FX, it seems to be now *or soon*. A combination of cheap premium and the prospect of a global recovery already apparent in the data suggests that the period of low vol will not endure, and be associated with a weaker USD against the key majors.**

Fig 8 Volatilities Have Fallen to New Recent Lows



Source: Bloomberg LP

Gareth Berry
+65 6601 0348
gareth.berry@macquarie.com

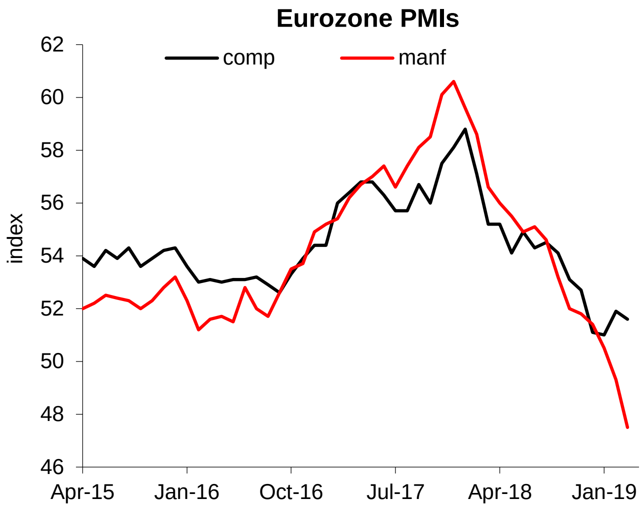
Eimear Daly
+44 20 3037 4802
eimear.daly@macquarie.com

The Euro: Upside beckons

We keep our gently-climbing EURUSD forecast profile, but marginally bump up the near-term forecasts to reflect the sudden turnaround in China economic data and to capture the rising chance of an early breakthrough in US-China trade negotiations. **EURUSD to 1.15 by end-June, then on to 1.17 by year-end.**

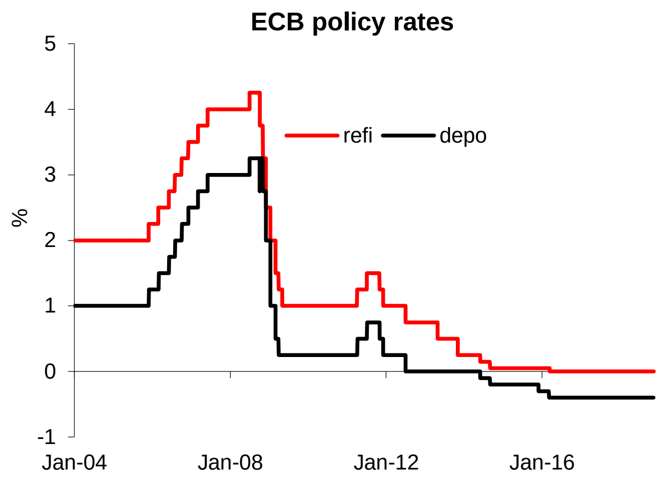
Defused global trade tensions would go a long way towards boosting Eurozone manufacturing PMIs, which already stand to gain a little from the 6-month Brexit postponement. **And wherever the Eurozone PMIs lead, EURUSD tends to follow.**

Fig 9 Corporate mood poised to rebound



Source: Bloomberg, Macquarie Strategy

Fig 10 Policy ammunition is depleted on the rates side



Source: Bloomberg, Macquarie Strategy

That's not to say the euro is entirely out of the woods on the trade front. **Not by a long shot.** Some residual caution is warranted for several reasons:

(1) **Geopolitical rivalry** means US-China trade tensions are likely to simmer for years to come. But a limited deal is achievable. Any compromise sold as a US negotiating victory would be helpful heading into the 2020 presidential election, especially if US equities respond positively to the news.

(2) **The threat of US tariffs on EU auto exports hasn't gone away**, but we see grounds for optimism here too. The EU has just agreed to open formal trans-Atlantic talks to explore how tariffs on a range of manufacturing goods can be lowered. **It's early days, but that's a good start**. Admittedly, a long-running dispute over alleged subsidies to the EU airline industry has escalated recently, which some regard as a bad omen. But we were encouraged to see **the US go through the proper WTO arbitration channels this time**, rather than acting unilaterally.

(3) **Brexit continues to cast a shadow**, but at least Eurozone manufacturers can breathe a little easier for a while, safe in the knowledge that their supply chains and access to UK export markets will not be disrupted until Oct 31st at the earliest.

(4) **The details matter.** Although a US-China *rapprochement* would lift the global mood and boost global trade, the EU could be disadvantaged by any pledges China gives to increase its consumption of US exports. If US exporters win, exporters from elsewhere might lose some share of the pie, although this may be a greater threat to Australian agricultural and LNG exports.

Beware the month of May

Populist forces are very likely to gain seats in May's EU parliamentary elections, but the new arithmetic should still favour the mainstream status quo. So we're not overly concerned about the euro suffering heavily from this. Parliament's power is limited too – so much so that critics still lament the perceived 'democratic deficit' at the heart of the EU. The 28 heads of state still mostly call the shots, especially in sensitive areas of economic policy.

Still, the forced participation of the UK potentially increases the downside tail-risks here, even if we still judge them to be manageable. As a price for securing the Brexit extension, PM May has agreed to *“refrain from any measure which could jeopardise the attainment of the Union's objectives, in particular when participating in the decision-making processes”* of the EU. However, the UK’s MEP’s are not bound by the same pledge and some could try to make a nuisance of themselves, allying with populist forces from elsewhere in an attempt to increase their influence over parliamentary proceedings and decision-making.

The longer haul

Looking further out, we dial back our EURUSD bullishness into year-end but only fractionally. This reflects the diminishing chances of ECB policy tightening anytime soon — if anything, the wind is now blowing in the opposite direction.

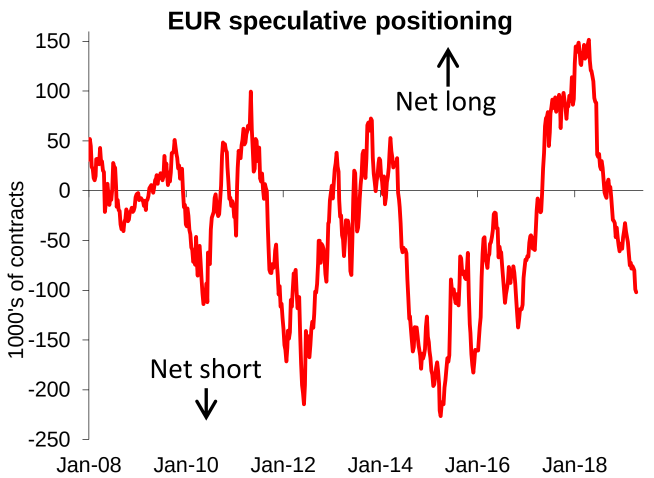
Steps to mitigate the harmful effects of negative rates on the health of the banking system are being considered. **There’s a subliminal message here that the market has picked up on**: it would not be worth the effort to do this unless the ECB intends to camp out in negative rates territory for potentially years to come.

Introducing a tiered system of negative interest rates would be one way of doing this, although not the only one. It would also be the most euro-negative form, potentially opening the door to further interest rate cuts. **Recall that the tiered system already in place in Switzerland has allowed the SNB to lower rates down to -75bp without sparking deposit flight.** Using the upcoming TLTROs to supply more euro liquidity at negative interest rates would be another potential avenue the ECB could explore.

Having made such a song and dance about this in recent weeks, **at least a token gesture from the ECB in this direction is likely in our view.** But any reform to how negative rates are implemented could still be several months away, and a trend towards modest but generalised USD weakness should be well established by then. Under the influence of these cross-currents **EURUSD still has some upside potential into year-end**, especially given the prospect of a more hawkish successor when Draghi retires on Oct 31st. An unwind of extended short EUR positioning should impart another mild tailwind too.

A ratings downgrade of Italy remains an ever-present risk, with six more opportunities before year-end. **But sub-investment grade territory seems a long way off yet (Fig. 12). So Italy becomes more of an FX issue in 2020 in our view,** although annual budget negotiations with Brussels in Q4 could become a temporary flashpoint again.

Fig 11 Speculative positions in IMM FX futures



Source: Bloomberg, CFTC. Macquarie Strategy

Fig 12 Dates of Italy’s upcoming rating reviews, including current ratings

Moody's (Sep 6th)	Baa3 (stable)
S&P (Apr 26th, Oct 25th)	BBB (outlook neg)
DBRS (Jul 12th, Nov 15th)	BBBH (stable)
Fitch (Aug 9th)	BBB (outlook neg)

Source: Bloomberg, Macquarie Strategy

Gareth Berry
+65 6601 0348
gareth.berry@macquarie.com

Trang Thuy Le
+852 3922 5718
trang.thuyle@macquarie.com

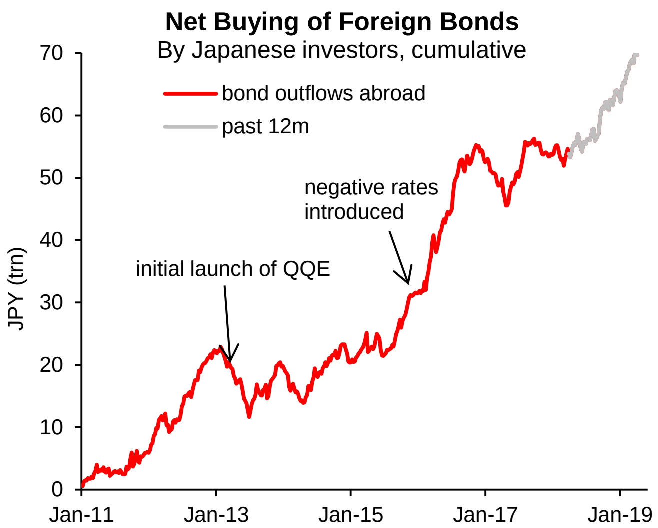
Yen: To weaken further as global growth recovers

USDJPY has remained resilient throughout the recent global growth scare, and has deftly navigated around episodes of elevated geopolitical risk too. So much for the safe-haven bid, which never seems to last more than a few hours these days.

We know why – Japanese demand for foreign bonds has been intense for the past 9 months, and that trend continues.

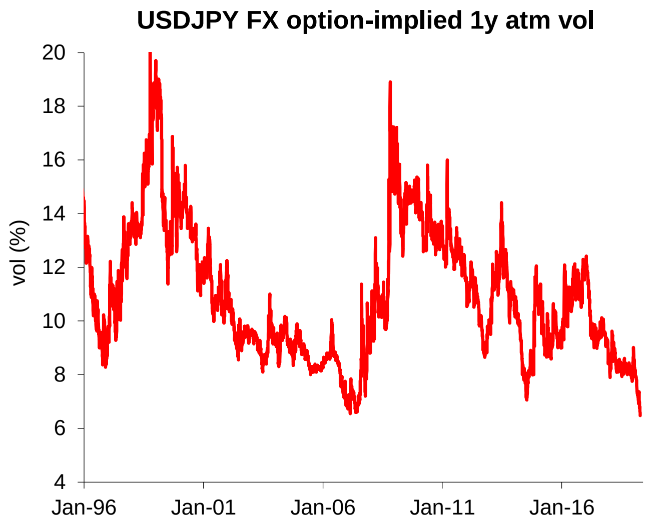
Now that the growth outlook is looking up and FX vols have dropped further too (Fig. 14), we have to assume the yen will weaker further, so we have raised our short-term forecasts to reflect this. **USDJPY to 113 by end-June, up from 109 previously.**

Fig 13 A bond buying spree is still underway



Source: Bloomberg, MoF, Macquarie Strategy

Fig 14 1y JPY vol has now sunk to a 25-year low



Source: Bloomberg, Macquarie Strategy

However, we still see plenty of scope for a turnaround and for yen strength to materialise into 2020. Whatever about the current cyclical upswing, global growth still seems to be locked in a long-term structural downtrend and policy tools left to fight back against it are limited.

All of this is fertile ground for a structural rally in the yen, and the Bank of Japan is virtually powerless to stop it unless it becomes even more inventive with its policy toolbox. We cannot rule out helicopter money – it would be the logical next step – but the hurdle is high.

We see USDJPY falling to 110 by end-2019, and 100 by end-2020.

Gareth Berry
+65 6601 0348
gareth.berry@macquarie.com

Eimear Daly
+44 20 3037 4802
eimear.daly@macquarie.com

Sterling: Unfinished business

Sterling still has a bright future, in our view. The whole Brexit saga is likely to end with a decision to stay in the EU after all, or to leave on terms that largely preserve the UK's existing trading links.

But given the risk of a hard no-deal Brexit has already receded, **sterling's best chance of a decent rally has passed for now.** So we flatten our GBP forecast profile, and kick some of the upside we had been expecting into 2020.

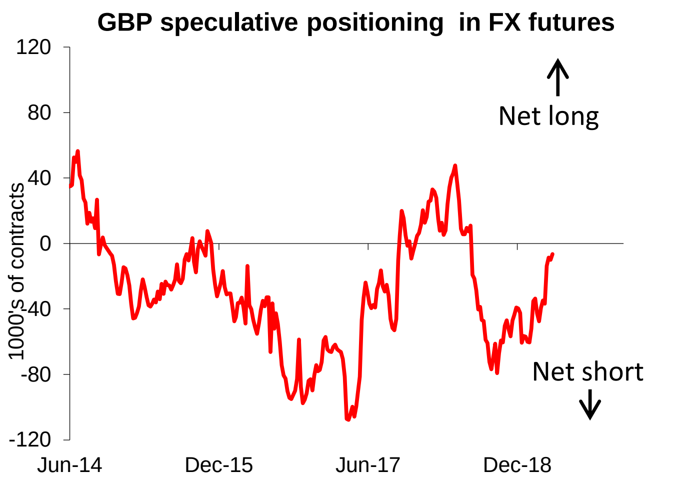
Cable should still get back to 1.40 eventually, but probably not until Q1 2020 now (a quarter later than we had originally expected). The likely Conservative Party leadership challenge should be out of the way by then, removing a key obstacle to a stronger sterling rebound.

Why hasn't GBP enjoyed a relief rally?

It has, but a weaker one than we anticipated. In January, hedge funds saw the House of Commons beginning to mobilise to prevent a cliff-edge accident on March 29th, and short GBP exposure was gradually reduced ahead of time. EURGBP is now materially lower YTD (5.1% on a spot return basis, 5.3% including carry).

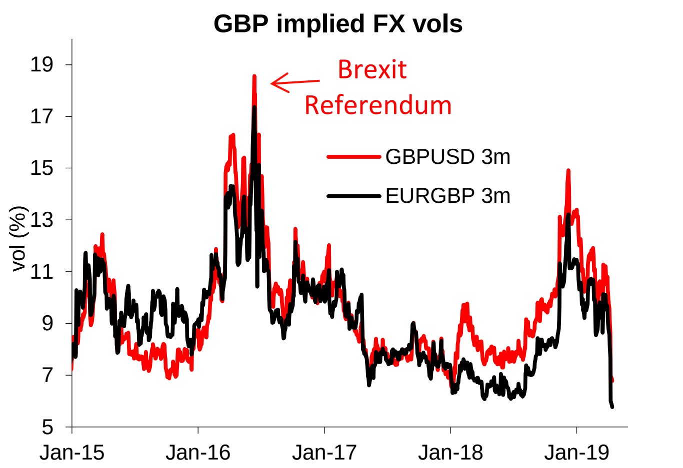
But the lack of follow-through since the 6-month Brexit extension was confirmed has surprised us. Extreme stresses had built up in the FX vol space until the last moment, but sterling spot has had a limited reaction even as these vol pressures subsided afterwards. **Such a spot-vol disconnect is pretty rare.**

Fig 15 Speculative investors trim their shorts since Jan



Source: Bloomberg, CFTC, Macquarie Strategy

Fig 16 Vols collapse as immediate Brexit risks subside



Source: Bloomberg, Macquarie Strategy

A longer-extension would have better-suited our bullish GBP view too; EU Council President Tusk had been pushing for twelve months rather than the six he ultimately got.

But the biggest missing ingredient is real-money participation; **our sense is that global investors are still deeply underweight GBP assets and probably will remain so until the Brexit fog has cleared (Fig. 15).** They have lingering concerns on a number of fronts.

Is sterling really out of the woods?

Some say the postponement has simply moved the cliff-edge to Oct 31st, and that we will face another nail-biting countdown before long. So there is little to get excited about.

There's a grain of truth to that, but we take a more optimistic intepretation. The Brexit cliff edge has been moved not once, but twice, which proves that **neither side really wants to see a hard no-deal Brexit.** The UK government's uncompromising rhetoric has been exposed as bluster, and the EU chose to be merciful when it could have let the clock run down past midnight.

This was not pure altruism on the EU's part. Europe is in no fit state to weather another economic and political shock. Arguably, keeping the UK inside the tent also prevents an agile competitor appearing in the EU's backyard, and it would be especially inconvenient if a departing country were to prove it can prosper outside the EU.

So to us, there's one inescapable conclusion from the past month: **another extension beyond the new exit date of Oct 31st would be forthcoming if needed.**

Unfortunately, prolonged uncertainty will not help corporate planning. So pent-up business investment will not be unleashed anytime soon. **But sterling still stands to benefit eventually from the passage of time, as the demographics work in favour of those campaigning for another referendum.** Opinion polls are slowly tilting in favour of Remain.

The coming change of leadership…

A change at the top of the Conservative Party seems overwhelmingly likely before year end. That's not a controversial view. But many expect a Brexiteer to succeed PM May, who would then quickly reset the UK's approach to Brexit and take it in a more confrontational direction — **this is the bit we struggle with.**

For a start, any would-be PM with genuine Brexiteer sympathies would first need to survive elimination by the parliamentary party in several rounds of preliminary voting, and it's unclear if enough support would be forthcoming during this stage**. Future party leaders tend to be those with fewest adversaries.**

Admittedly, victory would be assured if a Brexiteer made it through to the final two candidates and onto the ballot paper circulated to gross-roots members. Yet any new approach to Brexit would probably look a lot like the current one: fairly soft.

That's because the economic damage that would be inflicted by a hard Brexit is now better understood, which partly explains why **a number of household-name Brexiteers with leadership ambitions supported PM May's deal at the third time of asking.** Their logic seemed to be: if the UK is to leave, better to leave in an orderly way through this agreement, and then conveniently blame one's predecessor for any problems that arise later.

May's deal also imposes binding constraints on the degree to which the UK can diverge from the EU in future, limiting the freedom May's successor would enjoy to chart a different course.

In theory, a new leader would still have a blank canvas to work with until May's deal is approved. But they would also face the same remorseless logic: **accept the EU's terms, or else.** So it's hard to imagine them deciding any differently.

Still, we can understand market concerns around all of this. So perhaps GBP cannot extend its YTD rally <u>meaningfully</u> until PM May's successor is chosen and the first days of the new premiership are out of the way. **For that we might need to wait until December when her immunity to a leadership challenge expires.** A resignation could come sooner, but even that is still several months away.

The other downside risk holding sterling back…

The next general election is not scheduled until 2022, but defections have whittled the government's majority down to just a handful of MPs. Just a few more departures, and it will be hard for the opposition to resist the temptation to table another motion of no-confidence. **With the parliamentary arithmetic already so fragile, we see a 40% chance of an early election this year.**

A new government could come to power on the promise of holding a second Brexit referendum, **which would offer a way out of this Brexit stalemate.** But concerns around a new government's economic policies would <u>very likely</u> outweigh any benefit to sterling. A referendum could take a year to organise, **but economic policy could be taken in a controversial direction first – and far more quickly.** This early election scenario is not baked into our current forecasts.

A (minor) upside risk

Although political uncertainty will remain elevated throughout 2019, sterling should still be able to eke out some <u>modest</u> gains.

We judge that the UK is very likely to hold **EU parliamentary elections on May 23rd.** Electorate participation should be higher than usual as Remain-inclined voters mobilise in their droves. A strong anti-EU vote is likely too, despite suggestions of a partial boycott by some Leave supporters.

Crucially, the ongoing presence of UK MEPs in Brussels/Strasbourg afterwards **would keep the door ajar to reversing course seamlessly one day, and ultimately staying inside the EU.** This should help sterling over time.

However, there is a catch: when the votes are counted, the Brexit camp will likely be seen to have won the argument again. Leave supporters know exactly who to vote for, and can concentrate their firepower in that direction. But the options available to Remain supporters are more nebulous. How would a Remain supporter cast their vote to express their preference? Who would deserve that vote? It's not obvious, and so the Remain message could be drowned out in the confusion.

A bigger upside risk: the potential rapid game-changer

Separately, it's just-about-possible that May's deal eventually clears the House of Commons with Labour support, **which would be a strong GBP-positive.** It's not our base case. The odds do not look favourable. But if it did happen Labour involvement would mean an even softer Brexit, perhaps including a confirmatory referendum to endorse parliament's decision.

That would be the best of both worlds for sterling – the guarantee of a soft Brexit with the potential for none at all. If the newsflow begins to point in this direction over the weeks ahead, we would likely revise our GBP forecasts sharply higher again.

Gareth Berry
+65 6601 0348
gareth.berry@macquarie.com

Trang Thuy Le
+852 3922 5718
trang.thuyle@macquarie.com

The Aussie and Kiwi Dollars: Bottoming out

We keep our AUDUSD forecasts unchanged, and continue to look for a very gradual grind higher over the next 2 years.

Still, it's hard to see A$ staging a major bounceback with the threat of rate cuts hanging in the air. But equally we think the market has become excessively bearish, and a sustained dip below 70c looks unlikely to us.

The bearish A$ case hinges on falling dwelling prices and feeble income growth hurting household consumption, which then drives the unemployment rate higher. RBA rate cuts would follow **and a lower policy rate would mean a weaker currency.** That's the theory at least.

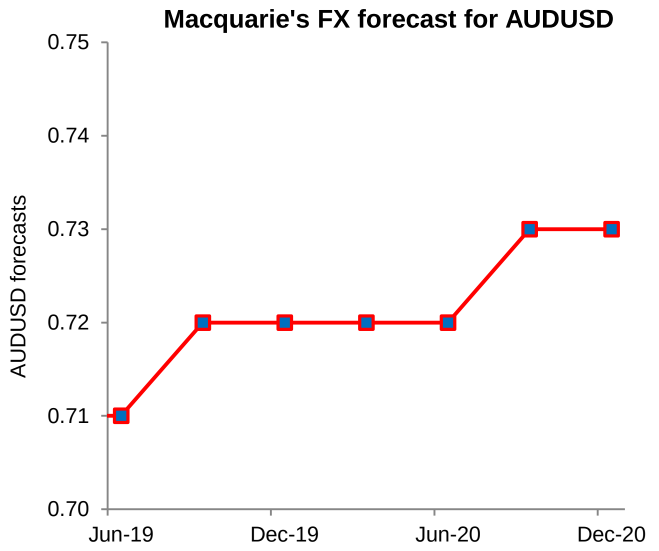
Trouble is, the two cuts that our economist Justin Fabo anticipates (in Aug and Nov) **are already mostly priced in to OIS rates and FX forwards**. So for AUDUSD to suffer even more from here we would need to see:

(1) a cut before August or

(2) an especially 'dovish' cut in August accompanied by firm signals that several more could follow soon afterwards.

Neither scenario seems very likely to us.

Fig 17 AUDUSD stuck in a rut, with mild upside potential



Source: Macquarie Strategy

Fig 18 Market already priced for rate cuts (indicative)

	RBA
now	1.50
May '19	1.477
Jun '19	1.444
Jul '19	1.380
Aug '19	1.314
Sep '19	1.281
Oct '19	1.248
Nov '19	1.184
Dec '19	1.169
Feb '20	1.165

	RBNZ
now	1.75
May '19	1.630
Jun '19	1.558
Aug '19	1.473
Sep '19	1.445
Nov '19	1.385
Feb '20	1.360

Source: Macquarie Rates trading, Macquarie Strategy

And we have other issues with the bearish A$ thesis too.

Although the domestic growth outlook is indeed challenging, and inflation is stubbornly low, the pace of decline in dwelling prices is already starting to moderate. **An eventual house price stabilisation would transform the psychology around the currency, even if that could still be several months away.**

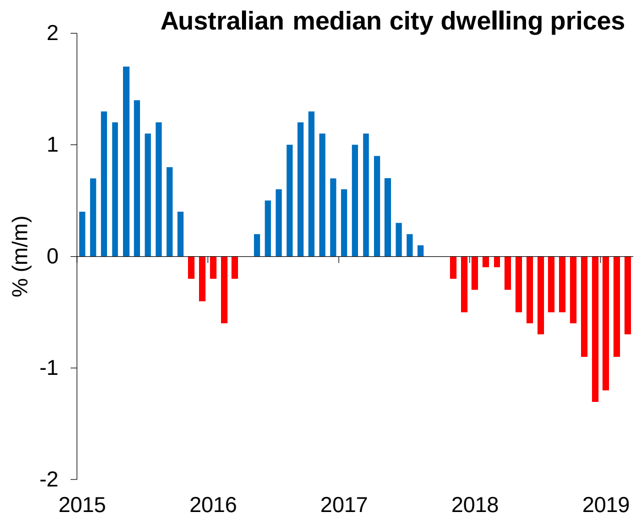
Until then, A$ can rely on its natural defences that we think are underappreciated:

(1) **AUDUSD is not as sensitive to interest rates as is commonly believed.** This stems partly from the dominance of reserve managers among the legion of foreign bondholders who are active in ACGBs. Inferior yields do not automatically trigger capital flight, if yield is not one's primary motive.

(2) Commodity prices are likely to stay firm, **driving Australia's monster trade surplus deeper into record territory.** Already the surplus is worth A$4.8 bn per month. Over

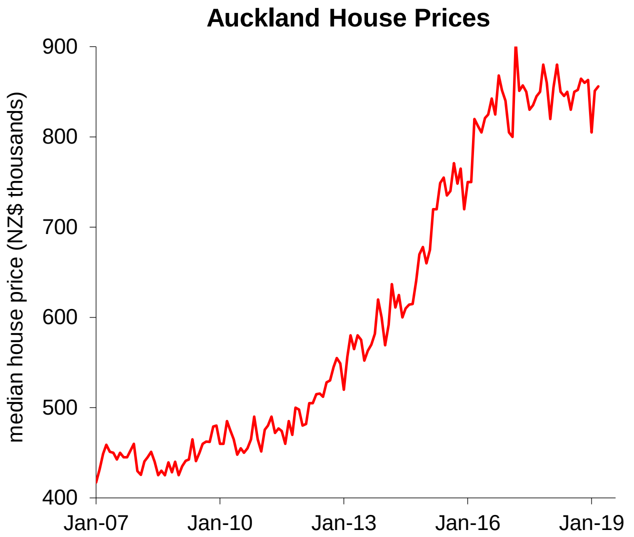
85% of exports are invoiced in US$, so that's a lot of AUDUSD to buy (even if we exclude LNG earnings, a chunk of which stays in US$).

Fig 19 Pace of property price declines starting to moderate



Source: Bloomberg, Corelogic, Macquarie Strategy

Fig 20 NZ house prices holding up, for now



Source: REINZ, Bloomberg, Macquarie Strategy

(3) The performance of **other currencies** against the US dollar matters hugely too. We judge that both EUR and CNY have some modest upside potential against USD for the rest of 2019, which should lend AUDUSD some indirect support.

(4) **A global growth pick-up looks to be getting underway.** Credit-based stimulus is flowing in China again and the latest batch of macro indictors, if taken at face value, suggests the adrenaline hit is working. Meanwhile idiosyncratic factors that had been holding back global growth appear to be fading, while **the prospect of a US-China trade deal is tantilisingly close.**

Meanwhile in NZ, the economic dataflow has not suffered any material deterioration in recent months and house prices have yet to succumb to the softness seen in Australia. Dairy prices have also had a good start to the year.

But none of this has prevented the RBNZ prepping the market for future cuts, in the form an unusally blunt message in the latest policy statement: *"the more likely direction of our next OCR move is down".*

Although directionally the comment leaves little to the imagination, investors are torn over the precise timing of when any policy easing will come through, and NZD should remain highly sensitive to dataflow into the next policy decision due on May 8th. NZ's quarterly employment report due on May 1st could provide the smoking gun, given the recent shift to a dual mandate that now incorporates a full employment aspiration.

Still, the Governor seems to be developing a reputation for catching the market off-guard, and the recent expansion of the committee to 7-members, where each member has an equal vote, further muddies the waters.

Our economist Justin Fabo thinks that May 8th is too soon for a cut based on the tone of the dataflow alone, but that the inherent dovish bias of the Governor means that a cut is a real risk.

Thierry Wizman
+1 212 231 2082
thierry.wizman@macquarie.com

The Canadian Loonie: An Idiosyncratic FX Story

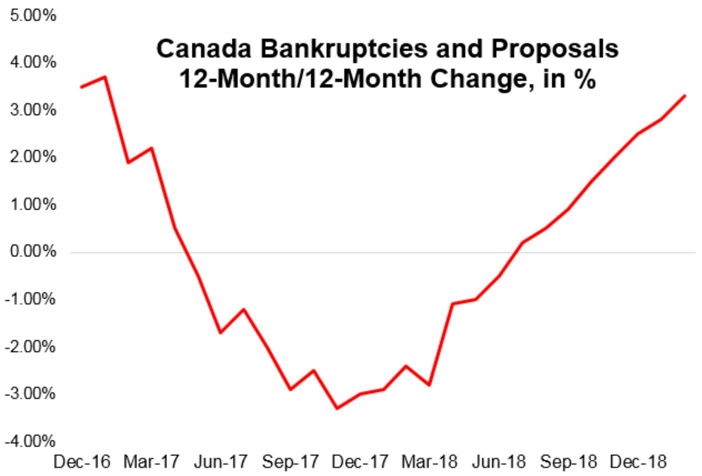
Trends in the global data have improved recently, led by the US and China, but also giving a fillip (so far) to Euro area sentiment and other ancillary measures of activity. In FX, the main outgrowth of this new trend has been the weakening of the USD vs. other DM currencies (e.g., the EUR, GBP, CHF, and AUD) since early April. But the USD has not weakened against the CAD, where FX performance vs. the USD remains lackluster. **Rather than think that the CAD will "catch up" to other non-USD currencies if global data improves further over the next few months, we see Canada and the CAD as an idiosyncratic situation, whereby it continues to depreciate against the USD *despite* better data globally.**

The reason is that Canada - and, by extension, the CAD – may have enough domestic overhangs to prevent a strong domestic recovery, and this may preclude rate hikes in Canada and keep the BoC "dovish" in disposition. In Europe, by contrast, much of the slump in activity since Q3 2018 (and lasting through Q1 2019), was related to weakness in international trade, which in turn affected manufacturing, industry, and transport. In Canada, the weakness has been seen recently in its domestic demand, predominantly, a problem likely rooted in the households' negative wealth effect as house prices decline, and in the context of high household indebtedness. These stresses are evident in the recent increase in personal bankruptcy rates, and the weakness in aspects of retail sales related to "leverage" – i.e., autos and furnishings.

Moreover, economist David Doyle has also recently highlighted how corporate debt is also high, and largely concentrated in construction and real estate companies. This run-up in corporate debt may be a mirror image of the mortgage-debt undertaking of households in the past ten years, but it presents another reason for why the BoC may demur from rate hikes, even in the context of global growth. **We also surmise that should some of the "good" events transpire in the next few weeks, such as a US-China trade war resolution, the benefits would be harder to discern for Canada than for Europe, which would benefit more from less uncertainty regarding tariffs faced by China.** In contrast, Canada could get trapped in the same risk that pertains to Mexico – that is, that US President Donald Trump will again threaten to "pull out" of NAFTA if the US Congress does not make headway in passing the USMCA, and this could happen against the backdrop of softening business expectations for domestic sales and as the number of companies reporting labor shortages declines, according to the BoC's Q1 survey of business.

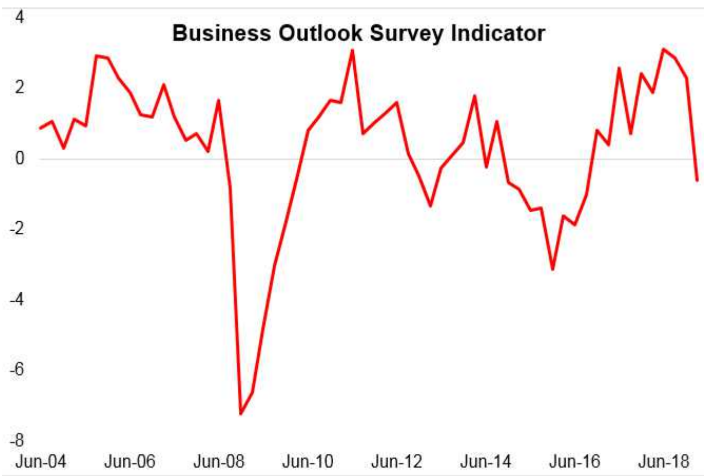
For its part, the BoC has continued to move its rhetoric in a "dovish" direction in recent weeks, the better result in the January Canada GDP estimate notwithstanding. One reason could be that the Governing Board wants to better align its outlook with the recent "dovish" tilt in monetary policy around the world. **But we suspect that a careful consideration of the data reveals that a "data dependent" BoC would have gone in a "dovish" direction regardless of the other central banks' new dispositions.** Indeed, at his comments during the recent IMF meetings in Washington, BoC Governor Stephen Poloz refused to acknowledge that the BoC has a hiking bias, leaving only a data-dependent outlook, and an implicit symmetric bias. We see the BoC "on hold" through 2019, and for the foreseeable future, a more "dovish" outlook than in the US, where the FOMC may still hike policy rates this year. As the challenges to the household sector grow into 2020-2021, the BoC may indeed cut, we believe, but more likely at that time, instead of before.

Fig 21 Household distress is climbing again…



Source: Office of the Superintendent of Bankruptcy, Macquarie Strategy

Fig 22 … and business is worried



Source: Bloomberg, Macquarie Strategy

Trang Thuy Le
+852 3922 5718
trang.thuyle@macquarie.com

The Chinese RMB: Appreciation to resume

Solid recovery in China economic data combined with the prospect of a near term US-China trade deal leads us to expect the yuan to lead Asia FX recovery in 2Q. We maintain our forecast for USDCNY at 6.65 in 2Q and 6.60 by year end. The risk is towards faster yuan appreciation versus our forecast, although anything beyond 6.50 is likely to face policy resistance.

We see fundamentals supports for USDCNY to finally break lower to the 6.60-6.65 range, after being held back around 6.70 for the last 2 months.

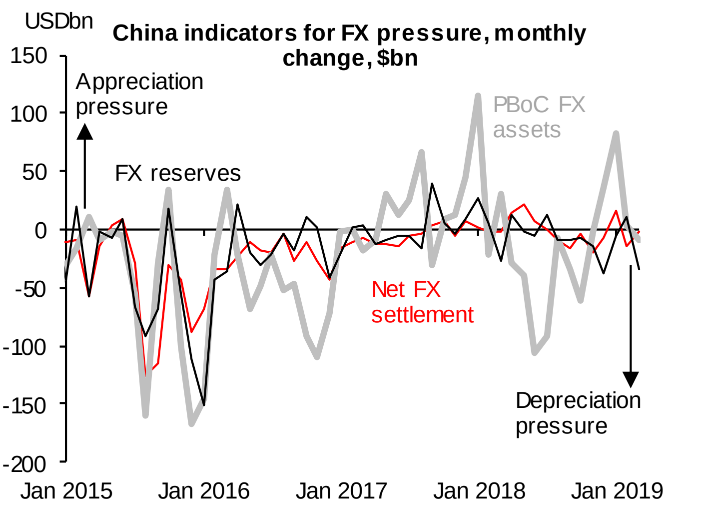
Concerns around China growth have receded following strong positive surprises across trade, credit and industrial activity in March. Seasonal distortions alongside front-loading stimulus mean March probably overstates the underlying trend, but the picture of China economy now is undoubtedly one of stabilization and improvement.

Policy appears much more pro-active when it comes to stabilizing growth. The large 1Q easing of credit which beat all expectations is one example. While PBoC seems to have shifted more cautious now after March data improvement, reports that the NDRC is working on new measures to boost consumptions including subsidies for cars and home appliances will help reassure the market that policy makers could quickly resume stimulus should growth momentum wanes.

Most indicators for FX suggest balanced supply and demand up to March (Fig. 23) as a recovery in the trade surplus helps make up for slowing portfolio inflows. Despite monthly fluctuation, **the trend for portfolio inflows into China equities and bonds should continue this year and even into 2020, supported by index events as we previously highlighted here**.

Following Bloomberg earlier announcement, FTSE Russell has recently put China on watch for a potential inclusion in their World Global Bond index in September. This alone would generate $100bn of inflows assuming $2trn funds tracking the WGBI and a 5% weight for China bonds once fully implemented.

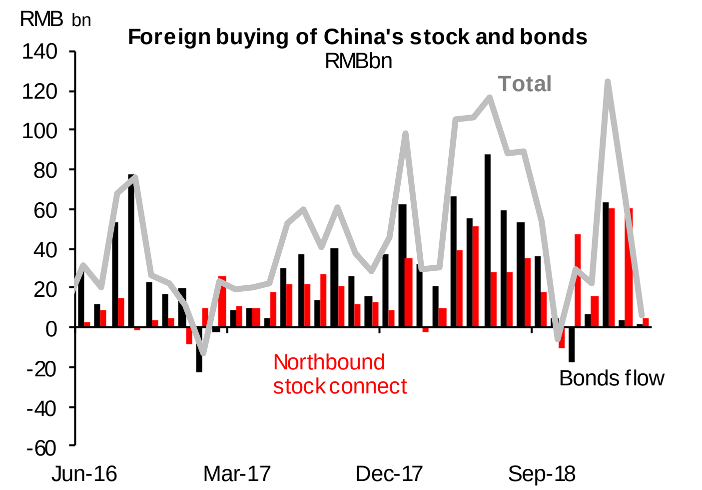
Fig 23 FX indicators point to balanced FX supply/demand up to March



Change in FX reserves are adjusted for valuations

Source: Macquarie Strategy, Bloomberg, CEIC

Fig 24 Foreign inflows slowed in march but the trend inflows should continue on index inclusion



Source: Macquarie Strategy, Bloomberg, Wind, CEIC

A US-China trade deal could crystalize better prospect for CNY.

- By now, financial markets have moved to price in a deal before 2Q, but confirmation will still boost consumer and business confidence, helping reinforce the broader global economic recovery we are expecting. This is important as broadening global recovery is crucial for our call for the USD to weaken.

- The market will also likely view any China FX commitment in trade deal as signalling policy bias for appreciation. We expect US-China to adopt and strengthen the currency chapter from the US Mexico and Canada (USMCA) trade agreement. This would entail China to commit against devaluation and publish FX intervention data either on a monthly or quarterly basis.
- In addition, China may commit to speed up CNY internalization and reforms of SOEs to boost productivity and lessen state intervention in the economy - policies to foster greater FX stability, and possibly strength in the long run (more details in CNY currency clause – from USMCA to Plaza Accord).

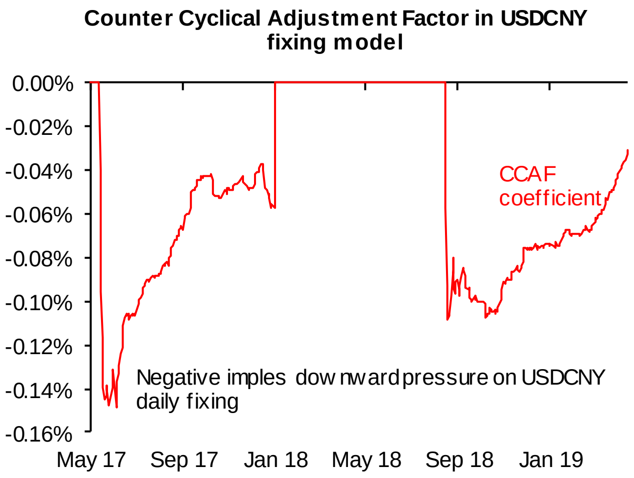
At the same time, several factors suggest to us that while prospect for the yuan has improved, appreciation will be measured this year:

- We forecast only modest USD weakness at a global level. The euro area growth seems to be bottoming, but evidence of a recovery remains weak, supporting only a modest EUR rally.
- Significant yuan outperformance will face China policy resistance. While PBoC is unlikely to intervene amid US agreement, we see scope for them to remove previous FX stabilization measures such as the Counter Cyclical Factor in the daily fixing and reserves on FX forward positions. These would act as signals to the market that policy does not support further appreciation.

In fact, PBoC has already steadily reduced the appreciation bias of CCAF on CNY daily fixing (Fig. 25). We estimate that CCAF, when first reintroduced in August 2018, helped lower USDCNY fix by about 60-70pips daily relative to a standard USDCNY fix model based on spot and basket only. However, its impact has dropped to just 20pips now. This signals policy intention is already moving to stabilize USDCNY from encouraging appreciation previously.

With implied to delivered vol already at post 2015 low, and the outlook we expect for spot to break out of the recent range, the likelihood is we will see some uptick in volatility as short vol structures got knocked out.

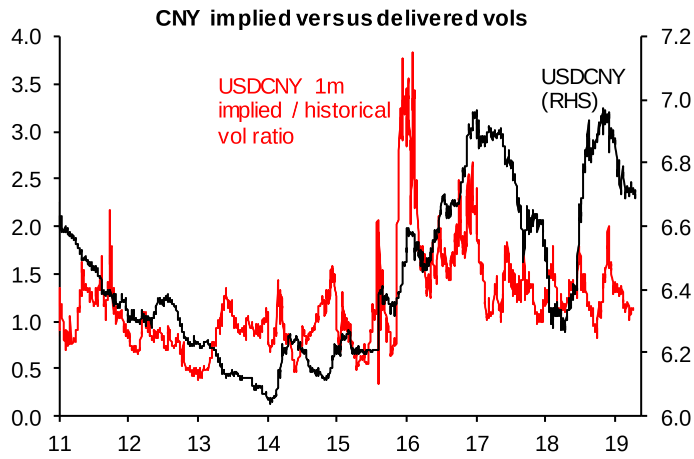
Fig 25 PBoC has steadily reduced the CCAF appreciation bias on CNY daily fixing



USDCNY 3 factor fixing model including changes in spot, basket, and a dummy variable for CCAF. Daily data.

Source: Macquarie Strategy, Bloomberg

Fig 26 A decisive break below 6.70 could see volatility rise slightly from current levels



Source: Macquarie Strategy, Bloomberg

Trang Thuy Le
+852 3922 5718
trang.thuyle@macquarie.com

EM Asia FX: Rotate to growth

Signs of stabilization in global growth momentum and our expectation for the USD to begin reverse weaker leads us to forecast Asia FX to gain ground for the remainder of the year. We also assume US and China will reach a trade deal by end of 2Q, further boosting sentiment.

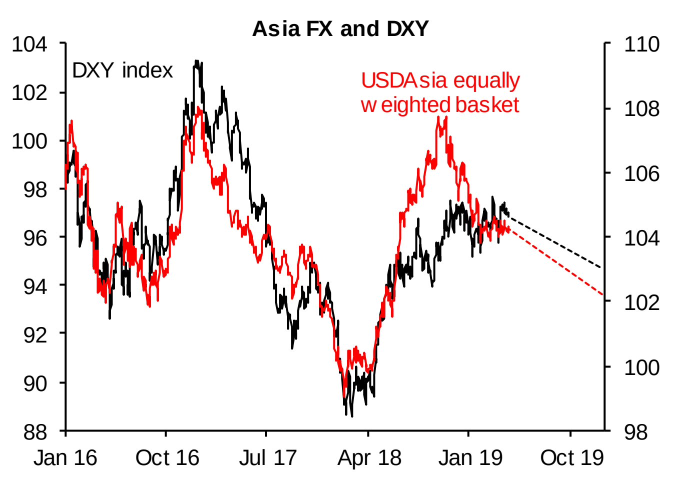
However, compared to the "synchronized global recovery" in 2017 which saw Euro area grow at an unsustainable rate above 2%, we expect a more modest reversal towards trend growth this time. This means that while the market will start to tentatively price for ECB policy normalization as global growth indicators improve, the process will be very gradual, supporting a slow grind in EURUSD to 1.17 by year end from 1.13 currently, a far cry from its 14% rally in 2017.

For DXY, our G10 forecast implies about 2% depreciation by year end, compared to its 11% drop in 2017. We think this will translate to 1% to 3% appreciation amongst Asia FX from current levels.

Overall, we see room for KRW and TWD to reverse their 1Q underperformance and lead rallies in the coming months alongside CNY. SGD is also likely to do well with weaker broad USD and continued modest NEER outperformance. Meanwhile, we pared back our enthusiasm for the high yielders.

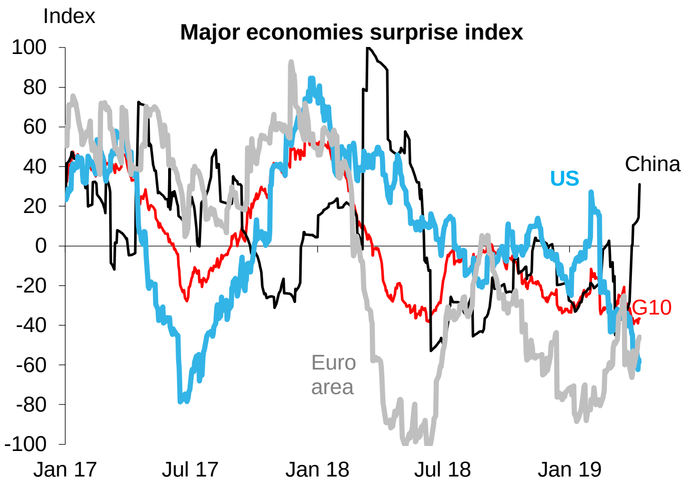
Our modest USD backdrop implies there is still significant room for individual Asia stories to drive FX divergence in the short term away from our forecast. We highlight some of the risks to our section below.

Fig 27 Modest fall in DXY expected in 2019 vs. sharp drop in 2017



Source: Macquarie Strategy, Bloomberg

Fig 28 Global economic data surprises have turned the corner, led by China



Source: Macquarie Strategy, Bloomberg, Citigroup

Global and China indicators so far support our view for a turnaround in growth momentum.

China is clearly leading the recovery with significant strength across industrial activity, credit and trade data in March. Measured as the difference between consensus and actual economic data releases, the positive surprises are clear for China recently. Meanwhile, G10 economic data surprises still look relatively depressed, suggesting sizable scope for "catching up" from here.

We see a global growth rebound benefit Asia FX in several ways:

1/ Support exports and current account position

EM Asia countries as a whole have seen their nominal USD exports contract by an average of 3% on trend from the peak in 2H 2018, with Korea and Indonesia suffering particularly badly as nominal exports contracted 10% in the last 3 to 6 months (our data are seasonally adjusted nominal exports. A 3mma is taken to further reduce the noise through our series).

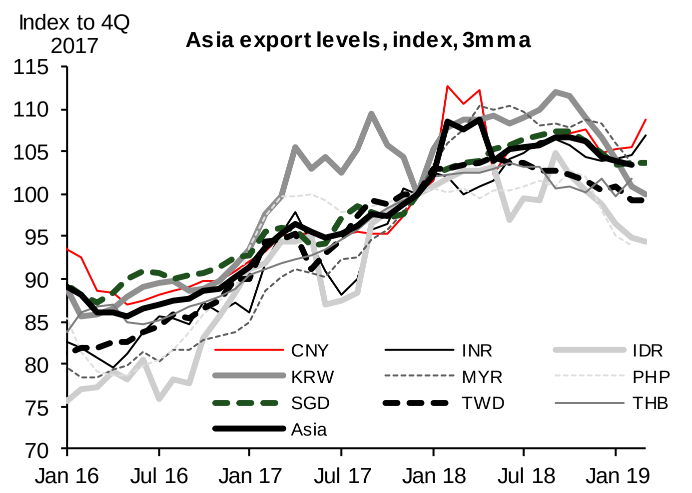
This sharp drop in exports have taken away a key support for the FX market – exporters selling of USD.

A rebound in global demand and exports we now expect should see exporters return to the market. For a change, we think exporters buying will be a dominant driver of Asia FX gains in 2Q and more meaningfully from 2H this year, compared to portfolio inflows.

While the market has gone some way to price in a US-China trade deal, a confirmation of a deal will still likely boost consumer and real business sentiment, driving restocking demand after a period of inventory rundown.

Our global team already sees encouraging signs from China's trade data in March, which will likely lead the recovery elsewhere in Asia.

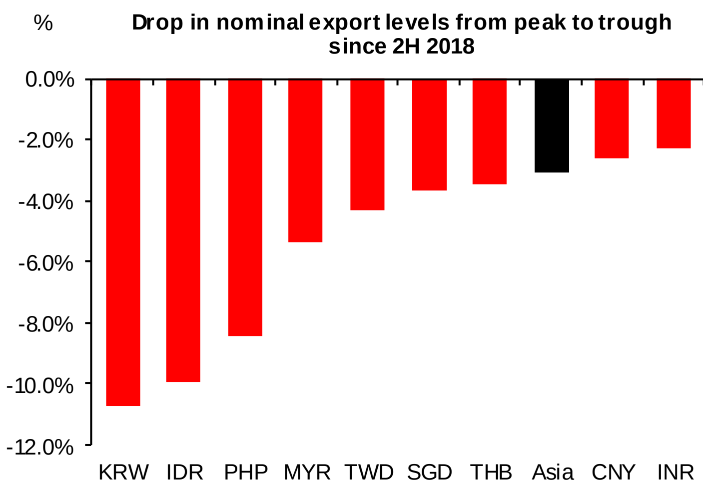
Fig 29 Asia exports have fallen sharply. Lack of exporters selling of USD a key drag in 1Q



Seasonally adjusted level exports in $bn, oil excluded for SGD and MYR

Source: Macquarie Strategy, Bloomberg

Fig 30 Korea and Indonesia have suffered particularly badly when it comes to exports



Seasonally adjusted level exports in $bn, oil excluded for SGD and MYR. A 3mma is taken to smooth out residual seasonal fluctuation

Source: Macquarie Strategy, Bloomberg, Citigroup

2/ Drive portfolio inflows, albeit with some divergence

While not necessarily boosting portfolio inflows further from current levels, better global growth indicators will at least support the case for a continuation of the recent inflow trend, in our view.

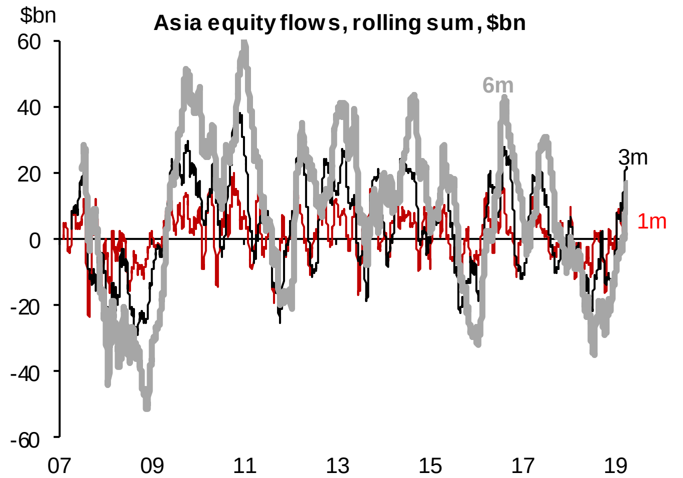
Equity inflows in Asia have been strong in the last month versus history, but not yet stretched considering a 3 to 6 months accumulation, and relative to large outflows last year. India is one exception where equity inflows look strong versus historical norm.

Meanwhile, except for Indonesia, bond inflows have been relatively weak. With growth recovery boosting global bond yields, the case for inflows into local currency bonds may look less attractive this quarter. We think inflows, if any, will likely be in concentrated in India if Modi returns to lead a government after the May elections.

China inclusion in major global bond and equity indexes presents a disruptive force to portfolio flows and could lead to more divergence prospect than usual for Asia this year.

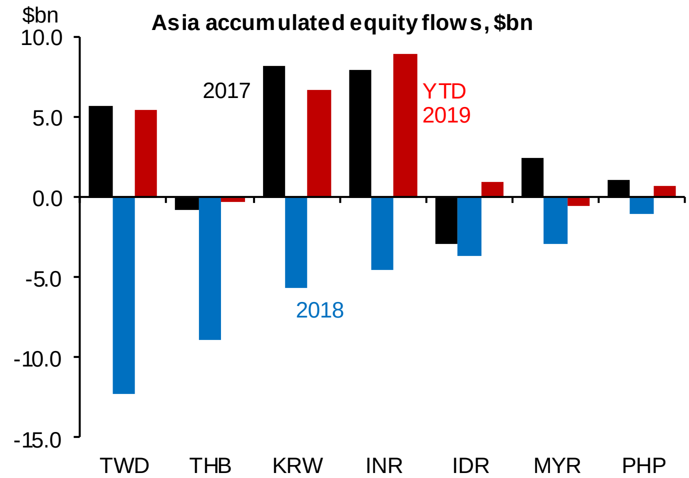
- We expect China MSCI inclusion starting in May, and then August to lead to passive outflows from Korea, Taiwan and India (see report).
- Similarly, China inclusion in the global bond indices – currently the Bloomberg Global Aggregate Index may lead to outflows Korea and Malaysia.
- FTSE Russell has also put China on watch list for a potential inclusion into its World Global Bond Index (WGBI), tracked by an estimated $2trn of funds. At the same time, FTSE is reviewing Malaysia for a potential exclusion – a move that could lead to $7bn-$8bn outflows from Malaysia bonds. A decision is expected only by September this year but has already seen some pre-positioning in the market.
- Finally, the recent Norway pension fund decision to cut its EM bond exposure will lead to an estimated $0.45bn outflow from Malaysia's and up to $2bn outflows from Korea's government bonds, some of which may have already been executed.

Fig 3 Asia ex China equity inflows are not yet stretched versus historical ranges



Source: Macquarie Strategy, Bloomberg

Fig 32 Except from India, inflows also don't appear stretched versus large outflows last year



Source: Macquarie Strategy, Bloomberg

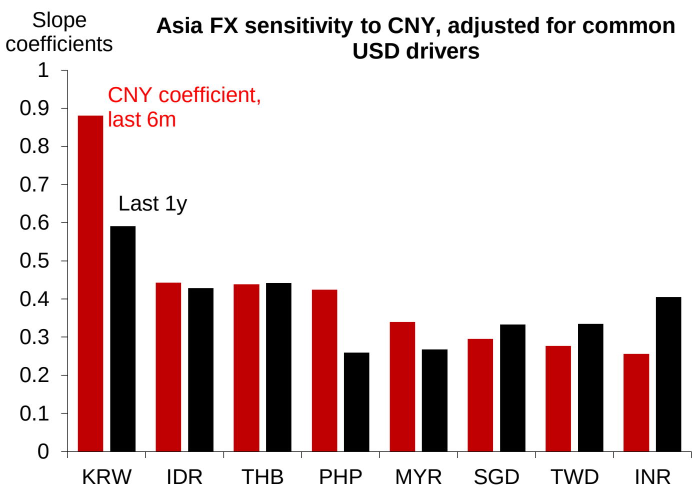
3/ A CNY led rally

To the extent that that 2Q boost to risk sentiment is led by a strong China rebound and a US-China trade deal, it is quite likely that CNY will be at the core of the Asia FX rally, leading the recovery in sentiment towards regional currencies.

As we note above in the CNY section, we expect a confirmation of a trade deal and China FX pledge for stability subject to an adaptive equilibrium to drive measured CNY strength to about 6.60 by year end, with a possible overshoot to 6.50.

Our analysis shows that KRW will likely benefit most from rallies led by CNY, given its sensitivity to the yuan (Fig. 33).

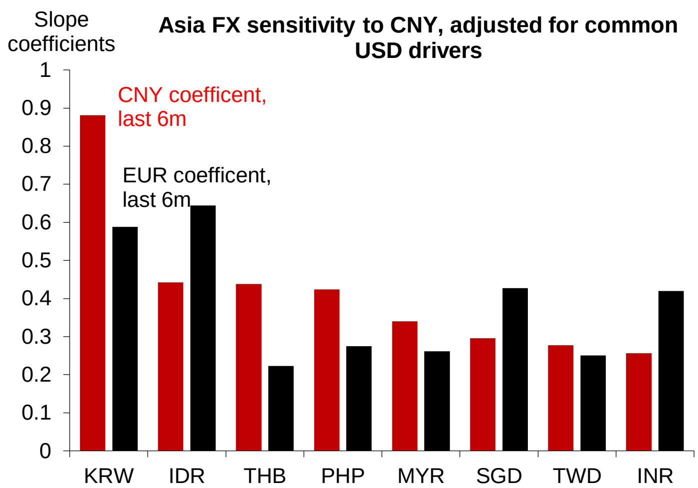
Fig 33 KRW is most sensitive to CNY specific moves, once common USD drivers are adjusted



Two stage regression: CNY was first regressed against majors to expel common USD drivers and a residual is obtained.
Each Asia currency is regressed against EUR, JPY and CNY residual. Regressions are based on daily changes, taking into account differences in trading hours between local markets and CNY.

Source: Macquarie Strategy, Bloomberg

Fig 34 In contrast, INR and TWD have lower sensitivity to yuan



Two stage regression: CNY was first regressed against majors to expel common USD drivers and a residual is obtained.
Each Asia currency is regressed against EUR, JPY and CNY residual. Regressions are based on daily changes, taking into account differences in trading hours between local markets and CNY.

Source: Macquarie Strategy, Bloomberg

We recommend positions in growth and surplus currencies

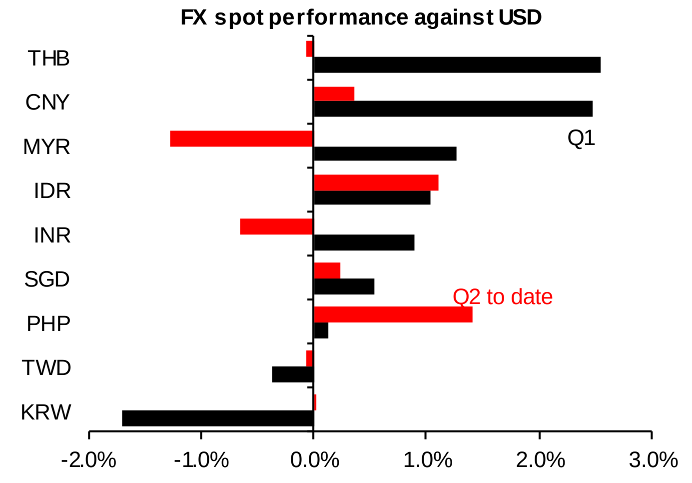
The outlook we expect above supports a rotation towards export-oriented and high beta growth currencies. **We see room for KRW and TWD to reverse their 1Q underperformance and lead rallies in the coming months alongside CNY.**

While weak Korea economy and the possibility of a rate cut from BoK may still weigh on won sentiment near term, we expect the market to focus on improving global indicators and signs of better global trade to support the won. Even if the BoK proceeds with a rate cut in May, it will most likely be one and done in our view. Seasonally, Korea's current account improves by about $5.4bn in 2Q following a trough in Jan/Feb.

SGD is a clear case in point where dovish MAS weakened the NEER only marginally as the market looks toward better growth indicators and continue to price some chance of a MAS tightening down the road. With NEER 1% annualized appreciation path and the weaker USD outlook we expect, SGD should also do well against USD and relatively to its peers.

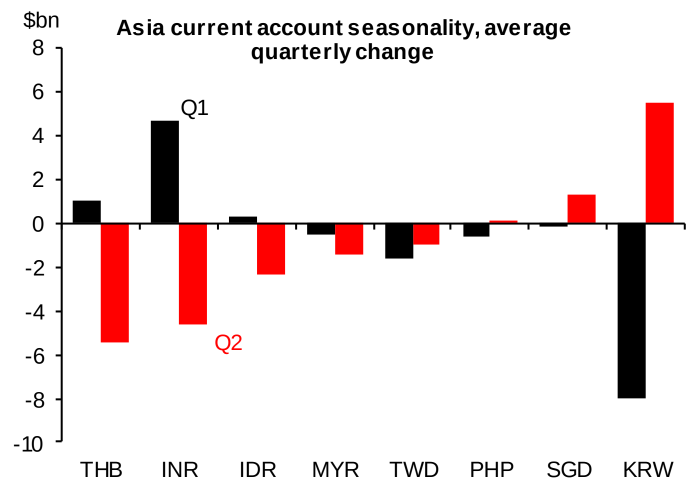
USDTWD has stuck in a tight range with diminishing volatility since November 2018. But there is prospect for change coming from new policy initiatives. Business profit repatriation may increase thanks to the government proposal for a new tax incentive scheme which offers preferable tax rates and rebates if the proceed is further reinvested in local productive businesses. Even without this scheme, we note that the adoption of Common Reporting Standard (CRS) in many countries, in particular China from September 2018 to allow regulators sharing of tax data has already led to a rise in Taiwan's business repatriation back home. The government's scheme could accelerate this inflow.

Fig 35 Scope for KRW and TWD to reverse 1Q underperformance as global trade rebounds



Source: Macquarie Strategy, Bloomberg

Fig 4 KRW is further supported by a seasonal improvement in the current account position in 2Q, while THB and INR suffer seasonally



Average quarterly change in current account balance from 2007 to 2018, excluding 08 and 09

Source: Macquarie Strategy, Bloomberg

Meanwhile, we pare back our enthusiasm for the high yielders.

While real yields continue to look attractive in both INR and IDR, we think a lot of good news are priced at current levels. Rising oil prices and higher global bond yields imply a less favourable backdrop for the high yielders relative to 1Q this year. To the extent that better global bond yields start to drive hawkish surprises from the Fed, concerns on Fed policy normalization could once again hurt deficit EM countries.

In India, a majority for Modi's government is mostly priced, so risk rewards being long INR here are not attractive. INR may still rally by 1%-2% if Modi majority is confirmed, but considering the low reliability of India polls, one should not rule out a last-minute surprise and sharp USDINR retracement higher should a hung parliament scenario plays out.

At a flow level, seasonal weakening in India current account position of about $4bn in 2Q combined with the recent move higher in oil prices suggests a more challenging funding backdrop for INR.

Equity investors have largely footed the bills so far with inflows at $8.8bn in India, strongest in EM Asia, but the pace may slow and profit taking is possible post elections. The case for bonds seems somewhat more positive as inflows have been subdued YTD ($220mn vs. Indonesia $4.9bn) and core inflation continues to trend lower to 5%yoy in March supporting RBI rate cuts. However, RBI intervention in the FX market and its USD swap operations are likely to put a floor on USDINR.

Similarly, we see the current global backdrop as less supportive for IDR versus 1Q. Large foreign bond inflows are unlikely to be repeated as the government has already front loaded 40% of its gross issuance need in 1Q and a rise in global bond yields reduces the attractiveness in bond investment. To the extent that Indonesia has benefited from election uncertainty and fiscal concerns in India, some of these inflows may reverse once India election risk is out of the way.

Finally, **MYR may underperform near term on the back of concerns on bond outflows.** Foreign investors hold 38.7% of Malaysia Government Bonds, of which 40% are asset managers. Bond index providers such as JPM GBI_EM has already cut Malaysia weight in recent years, in part reflecting weaker market access, but also inclusion of other countries such as Argentina and Saudi Arabia to its flagship indices. The negative FTSE Russel review, and the inevitable China inclusion in major bond indices will further reduce the attractiveness of Malaysia government debt over the year. We do not expect BNM to intervene heavily to defend the ringgit, but higher oil prices and a more supportive global backdrop will help mitigate some of the negative impacts of bond outflows.

Risks to monitor

While our outlook is generally supportive, the modest USD backdrop we expect still allows room for individual stories to drive short term FX divergence away from our forecast. Several risks we are watching include:

-Concerns on a double dip in China may resurface. Policy easing has been front loaded and the strength in credit growth in 1Q will likely assure momentum will be maintained through 2Q. However, our economist continues to see a risk of a double dip in 2H, absence more policy stimulus.

-A mishap in trade negotiation results in breakdown in US-China talks, leading to prolonged uncertainty, or even tariffs being escalated. We judge the chance of a complete breakdown is low as the stakes and desire to support equity markets are two high for both leaders. That said, a deal may still be delayed or slow to be finalized, leading to market disappointment.

-Trade war spreading outside of China. It is possible that as one deal is done, Trump will open the next battle ground. Trump has up to May 18 to decide on EU auto tariffs, which could have large negative impact on the auto exporters such as Thailand and Korea. However, we judge that even if Trump touts this possibility, exemptions are likely to be given to Korea and other allies where trade deals are already concluded. These would include Mexico, Canada and China.

- A known unknown of a May selloff. “Sell in May and go away” worked for Asia FX against USD in the last 7 out of 9 years post the GFC. Weak summer liquidity and events including euro area crisis and Fed’s taper tantrum have in combination created this pattern. We don’t know the exact trigger this time, but it is certainly a risk to keep in mind. With FX vols so low and investors already piling into short vol structures, an event that shakes this belief could lead to nasty price actions in low liquidity.

Thierry Wizman
+1 212 231 2082
thierry.wizman@macquarie.com

EM Latin America: Clarity, But Not Finality in Q2

Regional overview

If there is any overarching theme that prevails in Latin America in Q2 it is that we expect global growth to recover, led by the nascent recovery in trade volumes around the world as the dislocations of H2 2018 and Q1 2019 caused by the 'trade wars' start to fade. Should global growth improve on this trend (and we expect that it will), the resultant risk-on sentiment will be a boon for Latin America currencies, all else equal. And insofar as the recovery is coming earlier than most traders had believed it would (we had pegged the middle of 2019 for signs of a global recovery) it should also strengthen the non-USD currencies (including EM currencies) earlier than otherwise, too. However, the risk-on benefit to EM FX generally needs to be mediated through the lens of rising DM bond yields in Q2 and Q3, and the resultant decline in attractiveness of EM yields. **But growth, risk-taking, and higher DM yields are only a few of the several themes that pertain to Latin America.** Also important are the various reform efforts, especially in gov't budgets (Brazil, Colombia), trade issues (Mexico), structural impediments to growth (Mexico), shifting central bank policies (Chile, Argentina), and even migration in view of the Venezuela crisis (Chile, Colombia). We discuss these themes in each country below, and try to show how they inform our FX and rates views. **While Q1 2019 saw a nervous stasis prevail over Latin FX as traders waited for key themes to unfold, clarity will come to some of these themes in Q2 and H2 2019.**

Argentina: Killing Inflation Starts with Stabilizing FX

The past few months in Argentina have witnessed how an impassive monetary policy, *when backed up with credible fiscal policies,* can help stabilize the FX rate *and* be consistent with a (tentative) resumption of growth. Indeed, because the BCRA has made fighting inflation its #1 job, we are remain undeterred by the premise that inflation may rise indefinitely. We project that the USD/ARS will rise to 51 by year-end, although this projection is dependent on a "good" outcome in the national election in autumn. **If President Mauricio Macri or one of his proxies loses to the "wrong" candidate, all bets are off.**

In any case, Argentina has seen its share of shocks in recent months, primarily as inflation has surprised to the upside in January, February, and March. But not to be deterred, the BCRA responded to higher inflation with greater control over economy-wide liquidity and its own FX management policy immediately after the February and March "shocks". This gives us comfort, as we explain below.

- **Argentina saw another major disappointment on the inflation front on April 16 when monthly March inflation reached 4.7%, and year-over-year reached 54.7%, significantly above even the "whisper" consensus of roughly 4.1%.** Although much of the jump in headline inflation was food-driven (meat prices had surged in January and February too, and they constitute 7% of the CPI basket), core inflation also rose, putting to the test the idea that the spike may be temporary. Of course, utility and transport prices are still adjusting to higher underlying costs, as subsidies on public services are being reduced aggressively, from 3.6% of GDP in 2015 to 1.6% in 2019. (Completing convergence to base costs was to take place by year-end 2019.) As such, while inflation is high, long-term inflation expectations, were at least anchored at 2% monthly, *at least until the March spike was revealed.*

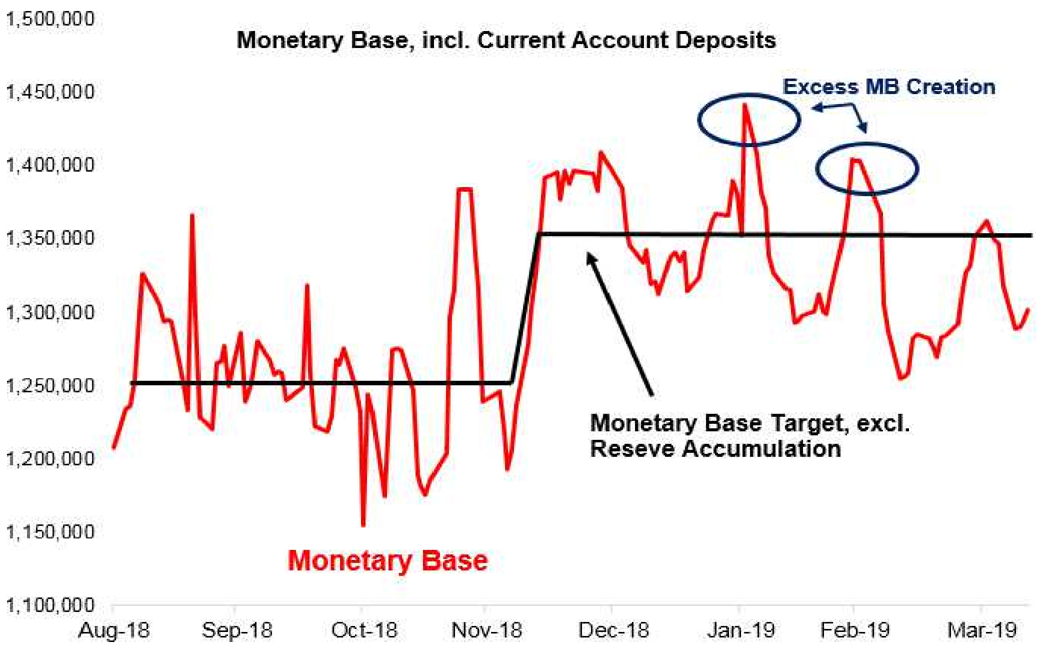
- **It is in that inflation context the central bank announced on 16 April another forceful change to its liquidity and FX policy framework.** The BCRA's non-intervention band, the range within which it does not intervene in the FX market, will now be *fixed* until the end of the year, instead of being modified daily with step-wise increments in the upper and lower bounds. The BCRA will now *not* intervene if it reaches the lower band at USD/ARS = 39.75, meaning that it will let the ARS appreciate (as per supply and demand), but will not let it depreciate above a certain limit (near 51.45). By this, the BCRA is signaling a ceiling to USD/ARS, perhaps acknowledging that the previous band was not very useful given its *width* and the *pace* of implicit depreciation in the upper and lower ranges. It is also a recognition that, the government (perhaps for political reasons) cannot allow FX depreciation. A more inflexible FX regime, of course, reminds us of the fixed-exchange rate regimes (which failed spectacularly in Argentina in

2000-2002, as well as in Asia in 1998-1999). **However, combining a fixed exchange rate regime *with full convertibility and a fixed monetary base (in which the BCRA cannot finance fiscal deficits)* is a different animal altogether. The BCRA has fixed the monetary base at ARS 1.35tr indefinitely.**

- We note also that the non-intervention range is not "absolute", in the sense that the BRCA may only intervene (at the top of the range, now) with "only" USD 160mn per day, as well as with the additional USD revenues it derives from export proceeds and the USD 60 million it earns through daily auctions of the instalments of the IMF loans. It is also not intended to lead to a large draw on reserves, now at USD 77bn. **This is just a potentially more contractionary monetary policy, in the spirit of the new framework that was introduced last October. With its fixed money supply as an anchor (at ARS 1.35tr, see Chart 2), that framework was intended to "channel" Paul Volcker, circa 1979 in the US.**

- **We note also that households in Argentina have, by now, almost fully dollarized their assets (at about 93% according to the BCRA), leaving little fundamental USD demand apart from speculative demand.** (Financial institutions may not hold USD assets.) **And capital flight is unlikely to take place when growth is improving.** Based on the data, the recession seems to have bottomed out in Q4 2019, as January and February's activity indexes have come out stronger, with exports, manufacturing, and construction leading the way. The agricultural sector, which helped trigger the Argentina crisis in mid-2018 after the drought of early 2018, is now having a very good harvest, with soybean output leading, and estimates of 2019 tonnage rising by 75% over last year.

Fig 37 Argentina's monetary base is fixed at 1.35 billion ARS

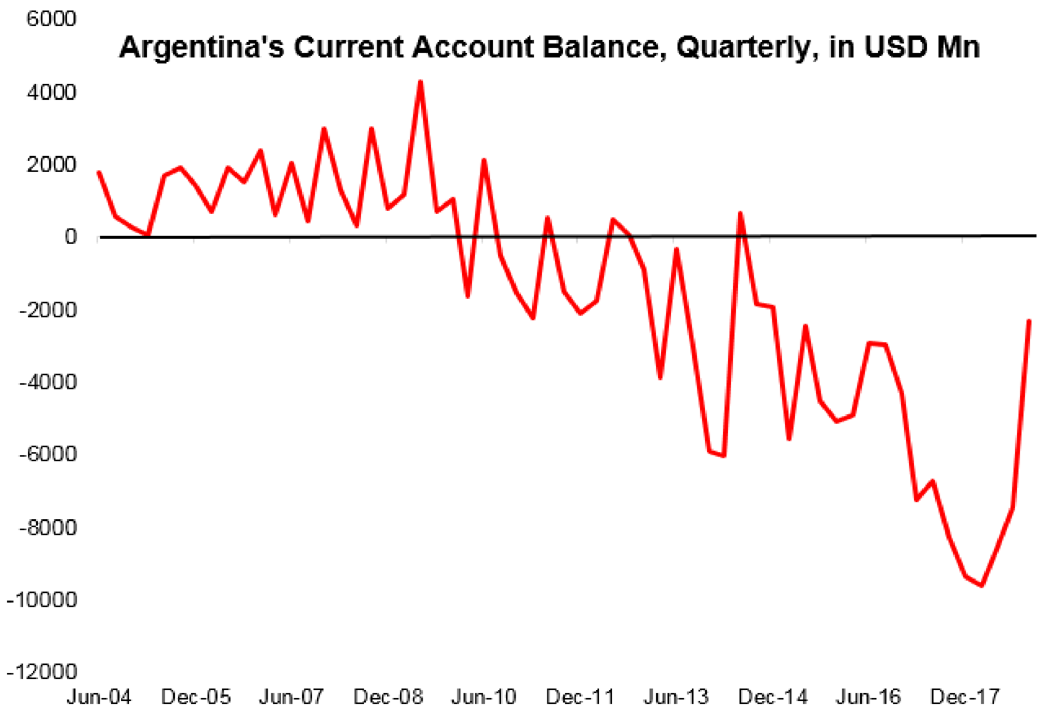


Source: Bloomberg LP

Are these measures enough to help withstand the next shock? No one knows for sure, but the government is trying hard to ensure that there won't be a "next shock". On April 17, the government said it would institute price "freezes" on 60 products (incl. mobile services, gas, and electricity). The government is advertising these measures as "short-term" only, revealing that they are purely "political", and reflect a need to ensure that Macri's poll standings don't decline further in the run-up to the election. Other members of the Cambiemos coalition have been lobbying the government for more "heterodox" approach to policy, so the measures likely also reflect the need to keep allies "on board" ahead of the election, and give them no reasons to "bolt". Practically, the impact of price freezes on CPI measures depend on their weight in the index.

Of course, it is hard to be impressed by the price freezes and agreements. Indeed, we suspect that although the government cleared these measures with the IMF, they faced resistance. The IMF may have simply conceded that should Macri lose the election, the return to sustainable growth would be impeded for a lot more than just six months. **However, the BCRA's measures on the monetary base and the FX regime "feel" right, and are consistent with the view that the government has made tackling the *structural problems* underlying the inflation problem (i.e., the difficulty with bringing long-term inflation expectations lower) a first order of business. Indeed, we would doubt that markets would take the price freezes well without the ancillary measures on the monetary side.**

Fig 38 Current Account Balance has already seen a sharp adjustment in Q4 2018



Source: Bloomberg LP

Of course, none of this may matter if the new monetary regime and fiscal regimes are abandoned because the election in 2019 goes the "wrong way". There is no assurance that President Mauricio Macri and/or the Cambiemos coalition will win the election. After all, the loyalties of the electorate in Argentina can best be described as 33% for Macri and 33% for the left-wing of the Peronist party, but with the balance of 33% in the middle or uninterested. **Under a slow recovery scenario with inflation peaking before May, we still see Macri as favored to win in a second-round run-off against a Peronist candidate, presumably Cristina Kirchner, and despite a still downbeat public mood.**

Brazilian real: Does it all Come Down to Pension Reform?

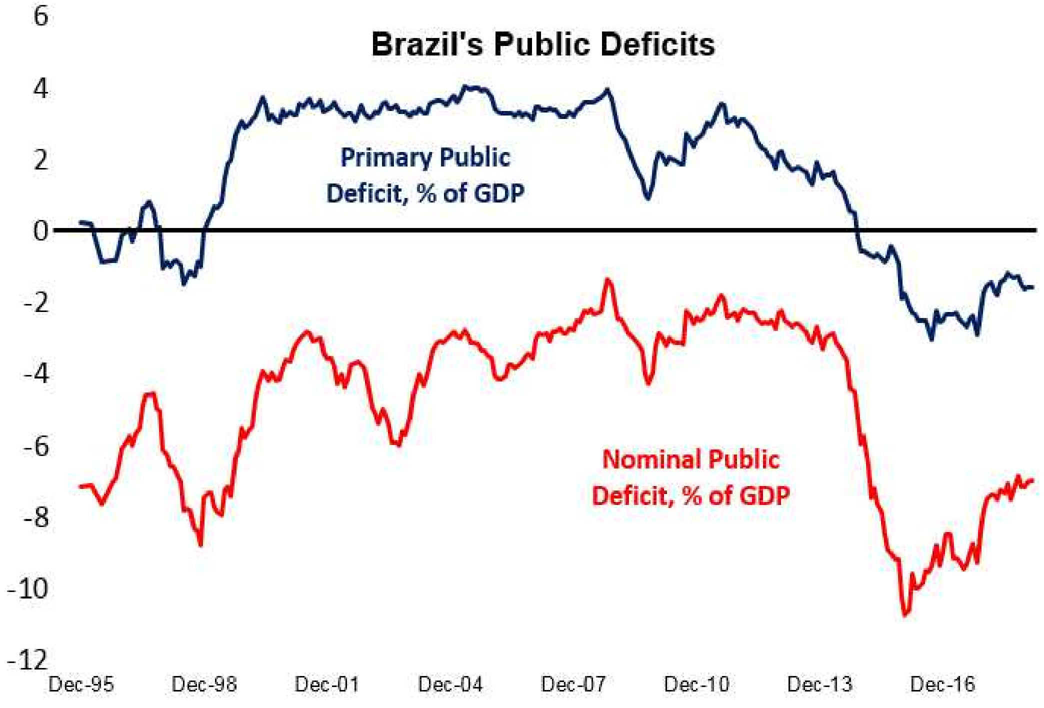
A cursory look at Brazil's situation reveals a few "positives" but also many "negatives" in the backdrop. Most importantly, Brazil has beaten back inflation, and the central bank (the BCB) is in relaxed mode. Second, the election of 2018 went the "right" way, installing an administration with an ambitious reform agenda with a "market-friendly" supply-side orientation almost unique to the history of the region, and focused on pension reform, tax reform, asset sales, and labor reform. The negatives, however, are that Brazil was in near-recession just as global growth began to slow in H2 2018, and the ensuing recovery in 2019 has been painfully slow. Brazil's neighbor (Argentina) is in a deep recession, too. And commodity prices have not yet seen a convincing recovery yet. **Since the election, we've had a positive view of the BRL, as we've seen the prospect of getting significant reforms passed as constituting a revolution in the structure of Brazil's economy, by fulfilling on the premise that trend growth could be as high as 4%.** Of course, political impediments would need to be overcome, but with popular support, Jair Bolsonaro could get a meaningful part of his agenda done.

But what has happened since January has been rising doubt about whether Brazil's Congress will allow *pension reform* to pass easily, after the pension reform was made a priority by the administration. The political fall-out from reducing the level of entitlements in the economy may be an important factor in keeping congress on the sidelines. And many congresspersons expect to run for Brazil's mayoralties in 2020, and don't want to be labelled as supporters of austerity. But Congresspersons have balked also because of Bolsonaro's refusal to play Brazilian politics by the "old rules" – i.e., offering patronage to Deputies and Senators that vote in favor of the reform. Personal disputes have also retarded progress. ***Throughout this process, Bolsonaro's approval ratings have declined.***

However, since early April, political relationships have repaired somewhat, but not enough to ensure that progress will be forthcoming soon. Economy Minister Paulo Gueddes has been engaging Congress in an attempt to move the pension reform bill through the relevant committees, taking a more active role in explaining the reform to congresspersons. And although party leaders will still demand greater participation from the administration in the *process*, including commitments from Bolsonaro to make patronage appointments and redirect "pork" in the federal budget, there has also been news that Bolsonaro is willing to be more accommodative on the way to "play politics". We believe that, ultimately, failing to pass the pension reform would hurt Bolsonaro more than trying to reform Brazil's "old politics" single-handedly, and he understands that too. **At that point, concessions from the administration will be more forthcoming, leading to a diluted, but still significant, reform being passed in Q3.**

Why is pension reform so important to the market? And why will the fate of the BRL turn on the success of the pension reform? For two reasons: First, tackling the pension system's large operating deficits is a requisite for fixing Brazil's endemic public-sector deficits (see Chart, below). Indeed, a deep entitlement & pension reform could cut 2.5%-2.7% of GDP from the public-sector deficit, according to the World Bank staff estimates, more than any other budgetary reform (see Table, below).

Fig 39 Brazil's deficits remain large



Source: Bloomberg LP

Fig 40 Greatest potential for savings comes from reforming pensions

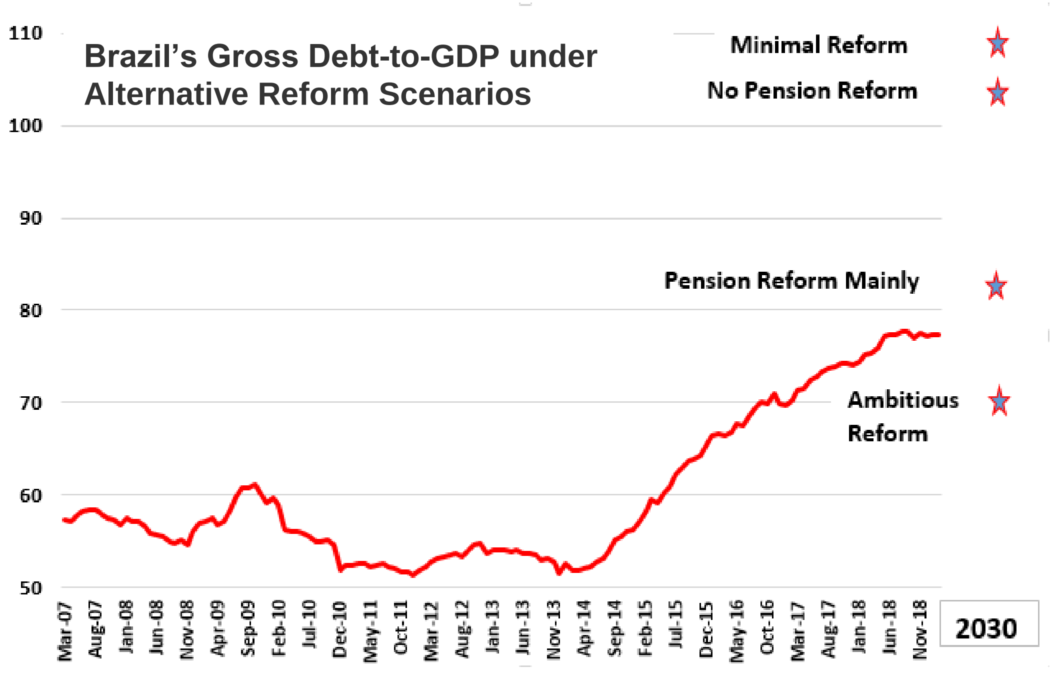
Expected Saving (as a Share of GDP) from Various Reform Initiatives

Entitlement / Pension Reform	2.5% - 2.7%
Improving Efficiency in Health Sector	0.30%
Eliminating Tax Deductibility for Private Health Plans	0.30%
Eliminating Inefficiencies in Education	1.50%
Aligning Public and Private-sector Salaries	0.90%
Tax Reform / Eliminating Targeted SME Tax Regime	1.0-1.2%
Eliminating Subsidies & Tax Expenditures for Industry	0.6-0.8%
Improving Public Procurement	0.20%

Source: World Bank Staff Estimates

But *without* controlling pension-related costs (by reducing the retirement age and raising premiums) Brazil looks set to see its debt-to-GDP explode by 2030, rising from roughly 78% currently to more than 100%, according to the OECD (see Chart). Brazil is undergoing one of the most rapid demographic-aging transitions seen in history, culminating no earlier than 2037 (when the share of 65-and-older persons will rise to 15% - from 7% in 2011). Combined with a pension system that is already generous, that demographic transition will raise the public-sector deficit further, ensuring that the pension system's deficit alone gets to more than 10% of GDP by 2036, from 3.6% currently. **Second, the common belief (although we disagree with it) is that if the administration can get pension reform done, other reforms will come easily, including tax reform – centered on the unification and simplification of the tax system.** Asset sales and labor reform are also key on the administration's agenda. While the pension reform is being given priority, the government is set to introduce tax reform in the next few weeks.

Fig 41 Under minimal reforms, the debt ratio climbs to 110% in 2030



Source: OECD Calculations

We will get a lot more clarity on the pension reform effort in Brazil in Q2, as the reform makes its way out of the Constitution and Justice Committee (the CCJC) and is reviewed by other committees. Indeed, in the first few weeks of April there has already been progress in this regard. The pension reform will likely see its constitutionality affirmed in the week of April 23, without major changes to the draft. The military pension reform will likely also be sent to congress for review soon, if it hasn't already happened at the time this report goes to print. The pension bill will go then to the special committee, starting in May, when we expect to see whether dilution takes hold.

In any case, the support in Congress looks like it is sufficient, but conditional, *rather than insufficient*. Newspaper *O Estado de S. Paulo* said that in its survey of the Lower House, only 69 deputies would approve the proposal *without any changes*. Another 129 would approve the pension reform depending on changes to the proposal. (The poll did not specify what would need to be amended.) Another 21 did not reveal their preferences, as they will negotiate their support later in the process. But these are likely to also support the reform conditionally. The combination of these three groups is much larger than the 308 votes needed for approval. Working against this progress, we continue to see Pres. Bolsonaro's popularity falling in the polls, and it is now the lowest among new presidents. **But it has stabilized at a level that is high enough to expect that his base will continue to offer its support.** And most important, the speaker of the Lower House, Rodrigo Maia, reaffirmed his support for the pension reform in meetings with investors in New York last week, and praised the Finance Minister. The implication is that he has repaired some of his personal divisions with the administration.

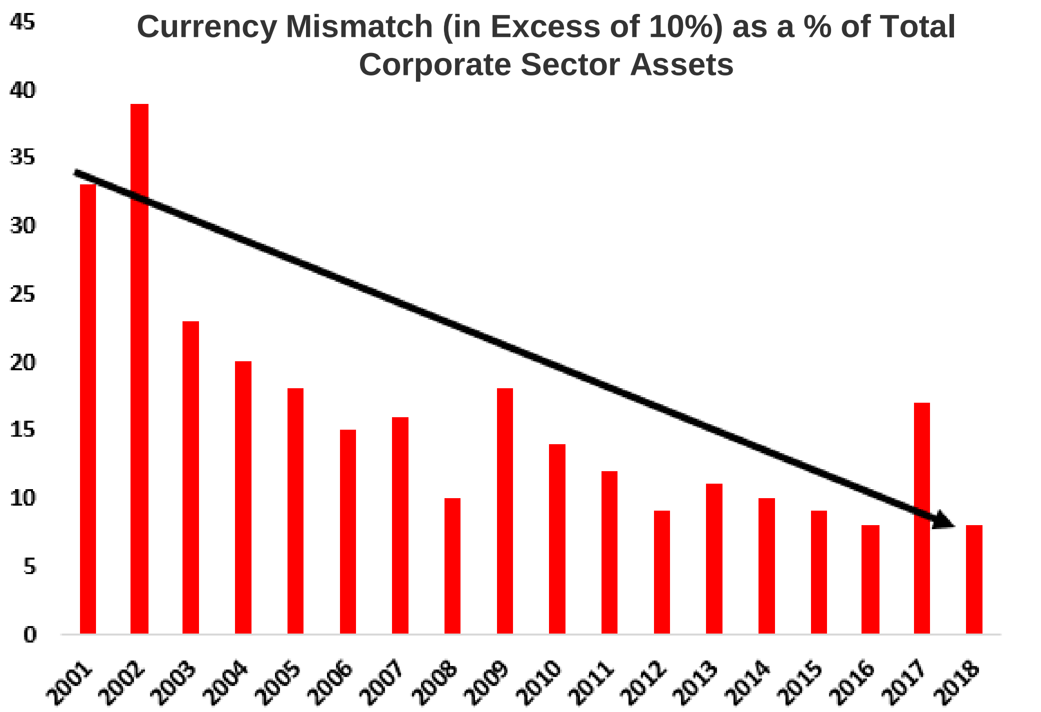
To summarize, we expect that the plenary of Congress will be considering the reform around the late summer, but dilutions are inevitable and delays are possible. Whether the pension reform is "significant" enough will determine whether traders cheer the BRL to outperformance. The administration's original proposal has been to save BRL 1.0tr over ten years. This may eventually be reduced through dilutions and compromises that exclude some categories of workers, or try to make the reform even more progressive than it already is. ***We think that the USD/BRL edges lower by year-end reaching 3.55.***

Chilean peso: Unless in-migration reverses, bias will be toward easing policy

Our thesis on Chile has been that the CLP will be primarily driven by just two or three underlying trends. Of primary importance is the direction of the economy's terms of trade. To an extent that is greater than for most other EM economies, Chile's terms of trade are determined by the prices of two commodities – copper and oil – as its exports are dominated by the former, and imports by the latter. Indeed, the ratio of the price of copper-to-oil has been an important determinant of the USD/CLP pair, as well as other crosses involving the CLP (notably, the CLP/COP). Through Q1 2019, the copper-oil price ratio has remained an important driver of USD/CLP, even though the absence of direction has kept the USD/CLP in a fairly tight range. With our view that China's stimulus is potentially intensifying to allow liberalization of the property market by mid-2019, the terms of trade alone hasn't given us a reason to be relatively bearish on the CLP in the back half of 2019. **Indeed, should China's stimulus "work", it would be to the benefit of global growth generally, industrial metals prices, and mining investment in Chile, *an important cyclical driver that could take Chile out of its own recent soft spot.***

Second, the central bank (BCCh) plays a secondary role in driving the CLP. Chile is an open economy, and relative cheapness in the CLP helps drive inflation and competitiveness, giving the BCCh a strong (and often underappreciated) interest in where the CLP goes. Yet, with the BCCH having a greater imperative to sustain employment in recent years, a weak CLP has usually not been met by policy tightening. **Rather, the BCCh has tolerated high inflation, as it did in 2014-2015 under a weak CLP phase when terms of trade were poor.** And while some economists have highlighted (mistakenly, in our view) how Chile's large gross external debt (concentrated at the corporate level) would induce the BCCh to defend the CLP in the event that the terms of trade turned adverse, this wasn't the case in 2013 and 2014 when Chile's terms of trade were also deteriorating sharply. Although Chile's private sector is highly leveraged in FX, accounting for 73% of Chile's gross external debt, Chile's policymakers have already taken macro-prudential measures, including the creation of a financial stability council, to ensure that indebted companies *are hedged* – either naturally or through financial hedges. Chile's companies have become increasingly hedged over the past decade. ***As such, the financial system can tolerate CLP depreciation.***

Fig 42 Chile's companies have reduced FX mismatch since 2001

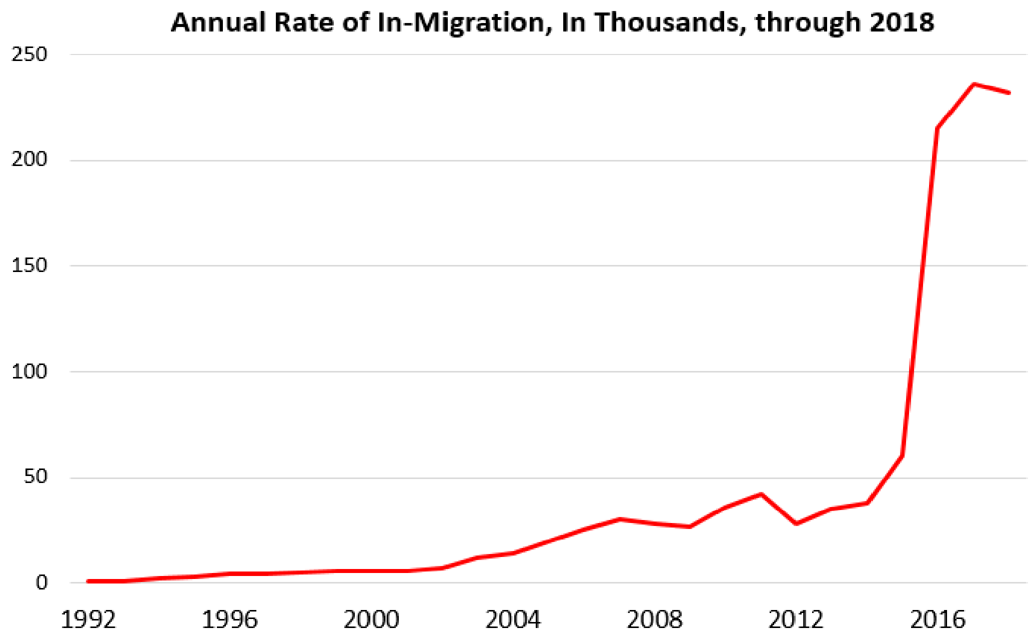


Source: Banco Central de Chile. Based on a sample of firms that report their balance sheet in pesos. Currency mismatch is the difference between foreign currency liabilities and foreign currency assets, less the net position in derivatives (the difference between buy and sell positions in derivatives contracts).

Thus, in recent months, we had offered the counter-consensus view that the BCCh would *not* stand in the way of a cheaper CLP should it happen, nor would it raise interest rates in 2019 given the lack of inflation. This view has now been supported by the BCCh's recent communications pertaining to its forward guidance, suggesting that it will *not* hike rates again in 2019, from 3.00% currently. Low inflation in Chile makes an on-hold outlook easier to justify, of course, and year-over-year CPI inflation below 2.0% (as of February) has motivated the "dovishness", so has the weakening of the economy since H2 2018. **A re-weighting of the CPI basket in 2018, resulted in lower inflation than under the former (2013) basket.** Other aspects of the inflation-formation process have also changed (such as price-based incentives in auto sales) allowing inflation to decline.

But according to the BCCh, a main reason to expect lower inflation structurally in Chile is the positive supply shock coming from in-migration, mainly from Venezuela in recent quarters. The BCCh stressed this in its recent IPoM, and in recent meetings during the IMF sessions in Washington. While the BCCh admits that it is difficult to measure the scale of this in-migration to Chile (in view of the difficulties associated with surveying immigrant households), it admits that it is very large, perhaps on the order of 800,000 persons in recent quarters. Yet because of the difficulty associated with incorporating the migrants into population censuses, the unemployment rate and the output gap are likely to be much larger than recently estimated. Hence, inflation has also been lower than the BCCh has projected. All told, the labor force may be 8% (!) higher than projected until recently (Fig. 43) . While the BCCH has not yet modelled the implication of in-migration for wage growth, it has cited the experience of Israel after the fall of the Berlin Wall in 1989-1990, which saw its own large-scale in-migration relative to the size of the workforce. At that time, real wage growth in Israel edged down to 0%, and the BCCh has admitted that Chile may be facing a similar situation (although real wage growth projections may not be released until mid-2019). **For CPI, a case for disinflation is not assured, but it seems likely, especially if new migrants have a higher propensity to stay in the labor force, and if a significant part of their earnings are remitted back to Venezuela (which would mitigate aggregate demand in Chile).**

Fig 43 Chile's in-migration has exploded, leaving excess supply of labor



Source: Banco Central de Chile

Indeed, the disinflationary effect of in-migration is one of the main reasons why, at the last policy meeting on March 29, the BCCh unanimously decided to hold interest rates at 3.00%, and added that it would be "keeping the monetary stimulus *for a longer time*." Following this, on April 1, policy-makers released their quarterly inflation report (IPoM), which made clear that they now assume a path for monetary policy that "does not include changes in the policy rate at least for the next two quarters." The IPoM also delved specifically into the implications (for the economy) of Chile's in-migration wave, and the document suggested that the BCCh does *not* expect inflation to return to the 3% target until mid-2020 – a timeline that is sufficiently far off that the BCCh may not *worry* about rising inflation for a long time. **The BCCh's own estimate of the equilibrium policy rate – i.e., a 4% "neutral" policy rate - is made even more moot.**

So we are left with the prospect that a global turnaround in mid-2019 will help the CLP (and other commodity currencies), but at the same time, that there will be a long period in which the BCCh stays 'dovish', rhetorically. The bias will persist, we believe, until the structural trends driving disinflation (namely, a larger output gap driven by in-migration) reverses. **Curiously, a risk to the low policy-rate outlook would be a peaceful transition in Venezuela, which would reverse in-migration, and make the BCCh more constructive on re-inflation, thereby getting it to be more "hawkish".**

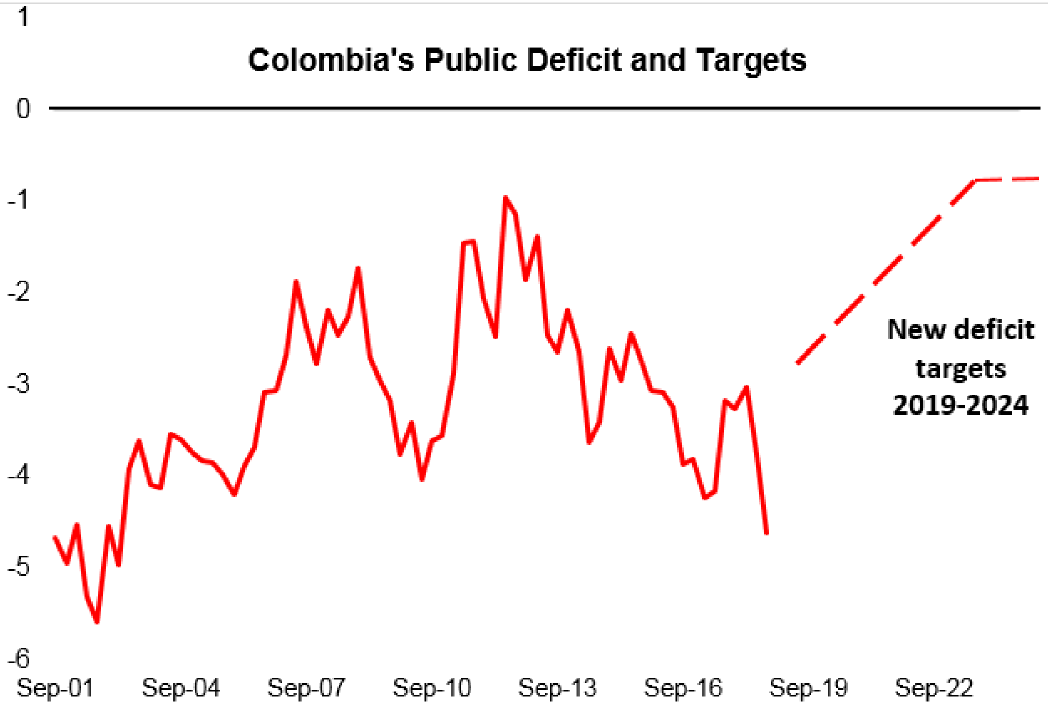
What could break the impasse and cause a major downward trend in USD/CLP (apart from a copper boom)? The third important driver of the CLP – i.e., stronger growth enabled by important improvements in reform-driven productivity and efficiency - could do the trick to strengthen the CLP. But for that to happen, we would need to see President Sebastian Pinera make serious progress with his reform agenda. That isn't happening yet, as pro-business reform agenda items (such as modernizing the tax and pension system, reducing administrative red-tape, etc.) remain hostage to the strength of Chile's left- and center-left parties, which remain prominent in the Congress. (Pinera's center-right party – *Chile Vamos* – controls neither the upper nor the lower house.) **So in view of ongoing low (or lower) interest rates, and despite higher global growth, the ongoing absence of reform means we have a projection of the USD/CLP reaching 675 by year-end – i.e., around the top end of the recent range of variation. This is lower than our projection in February (at 690).**

Colombian peso: Short-Term Fiscal Leeway, Long-Term Fiscal Reform, and the COP

FX traders' concerns and aspirations about Colombia and the COP have traditionally revolved around fiscal issues, and external issues (terms of trade, and the overall balance of payments). Yet because the price of oil drives much of the business cycle and by extension the cyclical component of the deficit, the price of oil has had an outsized importance in driving the COP. **Our baseline view of Colombia sees little risk attached to an oil price decline.** This view is also supported by the premise that global growth should rebound by H2 2019 (see the recent note from Vikas Dwivedi, here).

Nonetheless, traders remain concerned about the fiscal situation for reasons independently of the direction of the price of oil. Specifically, in the short-term, there have been concerns about whether Colombia would be forced into austerity measures in 2019 to meet its stringent fiscal target, thereby weakening the economy with pro-cyclical fiscal policy. However, a recent waiver on the deficit target from Colombia's fiscal rule committee will help avoid a fiscal spending crunch for now. The committee's waiver came after several weeks of public calls from President Ivan Duque's administration to have the deficit target better reflect the costs associated with in-migration of refugees from Venezuela. (That fiscal cost is roughly 0.5% of GDP over each of three years.) The fiscal deficit target will be 2.7% of GDP in 2019, and 2.3% in 2020 (from 2.4% and 2.2%, prior) – see Fig. 44. Colombia can now avoid any emergency asset sales, expenditure reductions, or new tax increases that would have been required had the deficit target not been adjusted. Colombia faced these choices even though the tax reform of 2019 had boosted tax revenue by 0.7% of GDP.

Fig 44 Colombia has to meet aggressive deficit targets in 2021-24



Source: Bloomberg, LP; Ministry of Finance of Colombia

Of course, an allowance for *higher deficits* in 2019 and 2020 does not automatically give comfort to *the rating agencies* (or long-term oriented traders) who must still worry about Colombia's longer-term fiscal stability. To calm the rating agencies, the fiscal committee also brought forward the timeframe for reducing the deficit to 1% of GDP to 2024 from 2027. The fiscal deficit targets for 2022 and 2023 are at 1.4% of GDP and 1.2% of GDP, respectively. These will be tough hurdles to meet, and so concerns about how Colombia will meet the targets, and the adjustments that would need to be made if it couldn't, will still give traders some jitters. These concerns may arise again as soon as 2020 or 2021, when corporate income tax reductions will kick in, and because the prospect of raising the VAT tax or broadening the VAT tax base will remain nearly impossible in the current political environment and during the remainder of Duque's term in office. (President Duque's original tax reform had called for a broader VAT tax base, leading to an additional 0.4% of GDP in tax revenue. But that aspect of the reform was rejected by Congress.) ***So Colombia's fiscal challenges are far from over and could (in theory) still lead to credit ratings downgrades after 2019.*** Fitch and Moody's have the sovereign rating at two notches above junk, but Moody's has a negative outlook. Standard & Poor's is a one notch above junk, with a stable outlook.

So should traders then remain concerned about the fiscal outlook still? Perhaps, but we wouldn't be overly concerned about a rating downgrade yet, nor a medium- to long-term fiscal performance erosion. Indeed, in our recent discussions with Colombia's Finance Ministry, we were encouraged by the government's commitment to structural fiscal reforms *based on controlling long-term expenditures, broadening the non-VAT tax base, and managing fiscal reserves.* Among the most prominent of the deficit-reduction proposals is the rationalization and reform of Colombia's 140 state-owned institutions; expect the government to merge or sell off these enterprises (especially for the low-dividend paying ones). The government will also reform the system of usurious interest rates paid on court-awarded obligations to the private sector; these payments amount to roughly 0.3% of GDP per annum. Excess liquidity at government agency accounts will also be managed with rates of return maximized, which can reduce 0.18% of GDP from the annual deficit. Tax compliance will also be improved through electronic invoicing; the Finance Ministry believes that only 70% of required taxes are actually paid, and that the tax-compliance measures will raise an additional 1.2% of GDP in taxes. **These and other measures could reduce the deficit by 2% of GDP.** Some will require congressional approval, perhaps coming as early as the summer (for some measures). **In any case, we expect that rating agencies will take these measures into account in their assessments of the sovereign rating and forestall any rating actions before 2021.**

Finally, the external accounts and reserves need to be considered when thinking about the COP. The current account deficit is expected to widen in 2019, from 3.8% to about 4.2-4.3% of GDP. Yet this expansion is likely to be driven by better domestic demand. In any case, for most of decade, FDI has almost fully financed Colombia's CA deficit, and should continue to do so. Fulfilment of fiscal rule, nonetheless, would become even more important if FDI were to weaken, and closing the CA deficit became a larger policy imperative. **For now, however, the larger policy imperative with respect to foreign transactions is to continue to accumulate FX reserves and bolster defenses against sudden capital flight.** BanRep began FX buying in September, though auctions of USD/COP puts that can be exercised with the BanRep whenever USD/COP falls below its 20-day moving average. Thus BanRep is putting a soft floor under USD/COP, ensuring that it is unlikely to decline precipitously.

The <u>Bottom Line</u> is that higher oil prices (since January) and the fiscal leeway granted by the fiscal rule committee has saved growth and the COP in 2019. These <u>*could*</u> resume as problems in 2020-2021. Traders will remain somewhat nervous in view of longer-term fiscal dynamics and the premise that the COP deserves a discount given the dependence of highly-erratic oil prices and uncertainty about fiscal stability. **But this will likely turn out to be too *pessimistic* a view, with hindsight.** At the same time, the BanRep's FX operations are likely to keep the USD/COP from falling precipitously, even in good times, although sterilization of these operations mean that they won't have a permanent effect on the FX rate. **For now, we expect the USD/COP to end the year at 3250, i.e., a mild move up that is borne of ongoing concern about fiscal issues and FX accumulation by the BanRep. But Colombia is in generally safe hands in regard to sovereign-risk issues.**

Mexican peso: Not stopping the madness, and vols are low

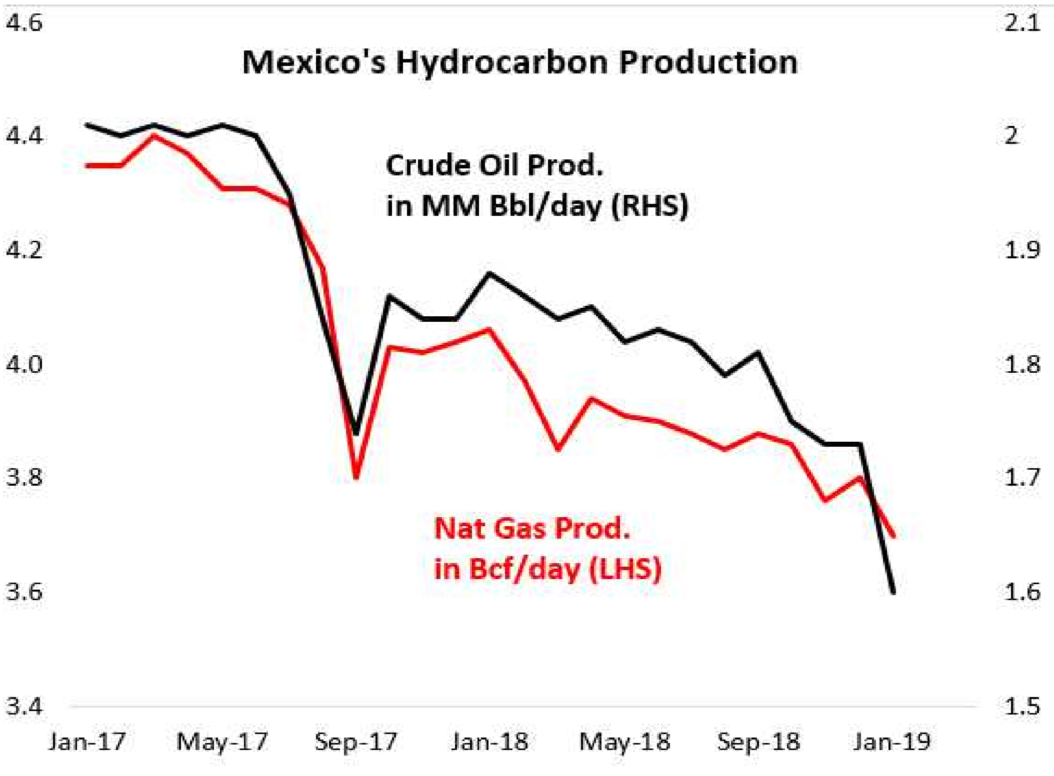
Mexico has seen some trends improve in recent months. Inflation in February, for example, has fallen below the upper end of the central bank's 2-4% target range. And while industrial activity has not recovered yet, the better data in the US augurs some stabilization in industrial activity in Mexico in H1 2019. A case can also be made that with consumer confidence readings still high, it is unlikely that consumption spending will drop off that easily, especially with employment trends still robust. **Yet our take on Mexico has been downbeat since late last year, as we've continued to struggle with the coherence, transparency, and market-friendliness of the policy innovations that have come out (and continue to come out) of the current administration.**

Indeed, in February and March, attention shifted away from the source of uncertainty that held traders attention in December and January (i.e., public referendums pertaining to initiatives such as the Mexico City airport project and new refineries being built) and toward

the more explosive issue of Pemex's balance sheet and the implications it holds for the federal government's fiscal health.

Even before the Pemex situation, Mexico faced a situation where some austerity was being imposed, as its oil-related receipts have declined and as *slower growth* has resulted in lowering of non-oil-related fiscal revenues. Recognizing this adverse trend in growth, the Finance ministry cut its GDP growth expectations for 2019 to 1.1%-2-1% (from 1.5-2.5%) and for 2020 to 1.4-2.4% (from 2.1-3.1%). The finance ministry also estimated lower revenues than originally anticipated. Government revenues are expected to decline by 0.5% of GDP in 2019 compared to what was approved in the 2019 budget as a result of lower oil revenues. The primary surplus target for 2019 was left unchanged at 1% of GDP and the 2020 target was set at 1.3% of GDP. To achieve this, spending for 2019 was also cut by 0.5%, while for 2020 spending was projected to decline by -3% *in real terms* compared to 2019. **Thus, the government is sticking to its austerity efforts for now, but the slower revenue growth risks becoming an ongoing problem for the government.** For now, as the government sticks to austerity, it risks breaking down the functioning of the public administration as bureaucratic salaries are curtailed and highly-paid bureaucrats are left to leave their posts.

Fig 45 Pemex's crude oil and natural gas output have declined sharply



Source: Pemex, National Gas Institute

But if AMLO is forced to decide between keeping fiscal austerity and keeping his programs, he would likely choose the programs, feeling that this will yield better macro outcomes. (His 'pet' programs include the youth trainee program at MXN 40bn in 2019, pensions for the elderly at MXN 100bn, the main infrastructure projects MXN 80bn. Under further pressure, the administration would extract new revenue from raising taxes or "raiding" the assets of semi-private entities. **For now, however, public salaries are the target, and the public accounts reveal that AMLO's public-salary cutbacks are ongoing.**

Fig 46 Mexico Finance Ministry's plans are conservative, on paper

Mexico's Budgetary Outlook (original, and April 2019 revision)

	2019		2020
	In the Approved Budget for 2019	In the Finance Ministry's New Plan	In the Finance Ministry's New Plan
GDP Growth (in %)	2.0%	1.6%	1.9%
Inflation	3.4%	3.4%	3.0%
Total Federal Revenue (as % of GDP)	21.3%	20.8%	20.5%
of which Oil Revenue	4.2%	3.7%	3.7%
of which Non-Oil Revenue	17.1%	17.1%	16.9%
Targeted Primary Budget Balance (as % of GDP)	1.0%	1.0%	1.3%

Source: Mexico Ministry of Finance

The federal government is *stuck with Pemex*, whose debts are excessive in view of the significant pace of decline in its crude oil production. Without investment, Pemex's shallow oil fields will continue to deplete, and deep water assets won't be tapped. The solution, of course, is to bring in more private investment, but the government has decided to support Pemex instead by transferring cash from the government's stabilization funds to Pemex instead. Tax and labor reforms would be pre-requisites for bringing the private-sector investment into exploration & production, but AMLO remains committed to upgrading and building new refineries instead, and has cancelled new concession auctions. The risk is that by *not* liberalizing the energy sector, AMLO is relegating Pemex to becoming dependent on sovereign aid, but not necessarily *enough* sovereign aid, out of fear that commitments to Pemex will soon impair the sovereign's credit standing, and lead the rating agencies to conclude that the burden of Pemex on the fiscal accounts may is too great. We recently calculated that a full bail-out of Pemex has the potential to take Mexico's promised primary fiscal surplus (or 1% of GDP) to a primary deficit of roughly -0.75% of GDP. In any case, under AMLO's promise to do whatever it takes to ensure Pemex's solvency, the rating agencies may conclude that the burden on the fiscal accounts may become too great, eventually. **Implicitly, the government cannot *buy* financial stability for Pemex without impairing its own finances greatly or bringing in private capital, which it won't do.**

More broadly, of course, Pemex's travails are a reflection of policies that seek to displace the private sector – policies that have also affected other industries, especially in the utilities, mining, and natural gas sector. For example, the government is still striving to renegotiate the terms of contracts awarded by the previous administration for gas pipeline construction, and reserves the right to take legal measures against the companies if no agreement is reached to change the terms of existing contracts. AMLO may believe that state-owned utilities were deliberately (mis-)managed for benefit private companies, and may wish to reverse this, but these policies also bring new risks for the financial health and management of parastatal companies, and the sovereign's credit standing. In order to promote these policies, AMLO's administration has co-opted government agencies that were heretofore independent of the executive, such as the Energy Regulatory Commission (CRE)

In Mexico, traders are not strangers to the prospect that the sovereign may be downgraded by end-2019 if the fiscal accounts worsen, either because revenue growth worsens, or because spending on the administration's pet projects is not capped and the deficit diverges from what is planned. But despite these risks, until now, *the MXN* has been saved, perhaps, by a central bank that has (rightfully) refused to cut the policy rate – on the premise that doing so might invite FX volatility and more inflation pass-through. Indeed, despite the start of a decline in inflation in February, Banxico's board has maintained a risk-management approach, citing the uncertainty surrounding Pemex and concerns over how some other government policies (minimum wage policy) may adversely affect resource allocation and take inflation higher. **By this, Banxico has reasons to remain wary of the prospect of capital flight and pass-through inflation.**

Banxico has other ancillary constraints on its policy, of course, too, including inflation expectations remain stubbornly high. Long-term inflation expectations, for example are near

3.5% in Banxico's own surveys, *the highest they have ever been*. In effect, Banxico has yet to convince traders that it is serious about achieving its point target for inflation of 3% even in the long-term, presumably because traders remain concerned that the administration will eventually capture the institution, resulting in inflationary policy. (This concern was heightened with the release of the most recent policy Minutes, when Gerardo Esquivel, one of AMLO's two appointees to the Governing Board at Banxico, had argued that the recent appreciation of the currency might hut the export economy.) **With this perceived loss of credibility, we expect that Banxico will keep the policy rate on hold (and high) at 8.25% at least through Q3, with the first cut expected in Q4.** This makes us more 'hawkish' than the Street's consensus, which is centered on a first rate cut between June and August. Indeed, with the positive base effect from spring 2018's lower inflation kicking in in spring 2019, and with energy prices rebounding, headline inflation may climb back above 4%, and core inflation may climb toward 4%.

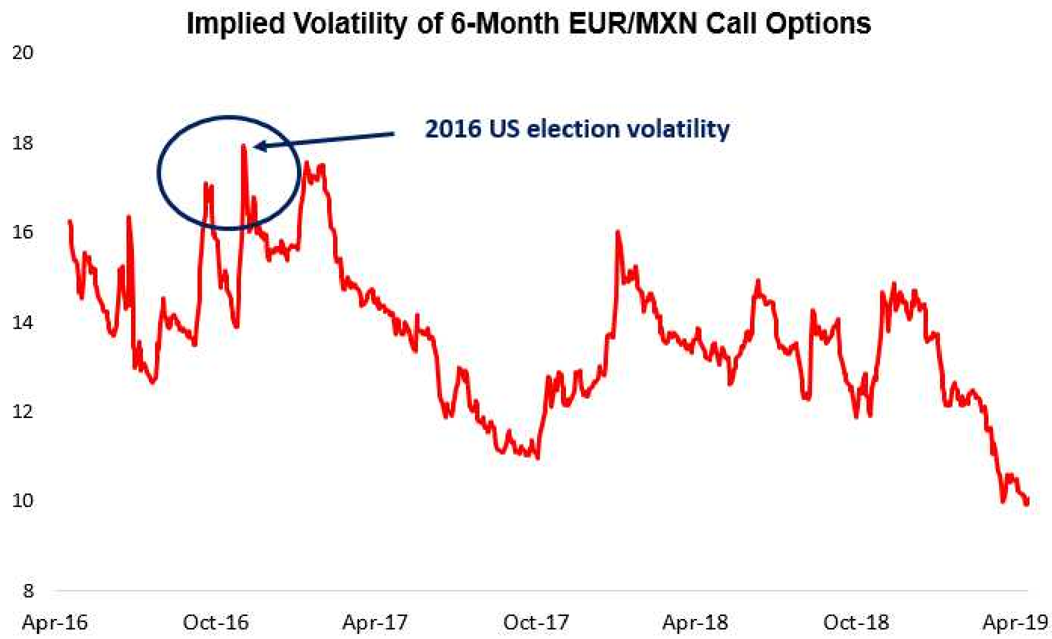
But we wonder whether tight policy will be enough to support the MXN in view of the various cross-currents that continue to dissuade real investment in the economy, namely the new administration's intrusion into the economy's key sectors and the fiscal slippage that country-risk analysts are watching. **In our view, high real interest rates may cause investors to stay in local bills unhedged, but the greatest structural threat to Mexico's balance of payments is that inward-bound FDI (rather than foreign money-market inflows) may suffer in 2019, and so we maintain an overall cautious disposition toward the MXN.**

We also note that another prominent risk that can hurt the MXN is that, in the US, anti-Mexico rhetoric will heat up again as we approach the 2020 election. We've already seen this with Trump threatening to "close the border" recently. He has threatened to put new 25% tariffs on "all cars made in Mexico and shipped over the border". It is unclear how Trump would impose such tariffs given that Mexico and the US signed a side letter in the context of USMCA negotiations that imposed a quota system for auto exports before any Section 232 tariffs could be imposed. (The quota was set at 40% above current production levels, and the side letters for this do not need to be ratified and are already in effect.) So Trump's threats seem to be for rhetorical effect. **However, they signal that Mexico will increasingly become the target of Trump's rhetoric as the 2020 US election vote approaches, especially if the USMCA (the "new NAFTA") is not passed by then.** And there are *several reasons* for why the USMCA won't be passed by then. Opposition from US Democrats and unions to labor provisions in the deal make its passage in the next few months highly unlikely. Trump's default would be to argue that he would "pull out" of the NAFTA treaty if congress withholds approval into the 2020 election. (*Canada's* Parliament must also ratify the treaty and Reuters reports that officials say the timetable is very tight in view of the summer recess in June, and the general election in autumn.) **Heightened rhetoric from Trump is another risk that keeps us relatively downbeat on the MXN, or upbeat on USD/MXN vols.**

Should the USD/MXN spike (say to 20.5) on Trump's rhetoric, we would not expect that Banxico would defend the MXN aggressively. After all, should the rally in USD/MXN be associated with concern over a NAFTA "break-up", Banxico may simply conclude that the real equilibrium exchange rate has shifted (in Mexico's disfavor) and so the USD/MXN should be higher. Intervention, in other words, would only be needed to smooth the path of a permanent rise in USD/MXN.

Our year-end projection of 20.5 for USD/MXN does not warrant a long USD/MXN forward hedge (given the high carrying charge), but the historically *low vols* <u>do make</u> buying gamma more compelling as a protection play, especially as we approach the 2020 election in the US. The reason, as we see it, is that in view of the discussion above, various prominent event risks – notably, a sovereign rating downgrade or harsh anti-Mexico rhetoric from the US – may ensue by end-2019. **What makes a lot of sense is to take advantage of the low vols (10.5% on a 6-month contract) in view of the high event risk in Mexico.** Buying a 6-month USD/MXN call or call spread (as discussed in the intro, above) would take advantage of the low current vol. Traders wanting to "hedge" that USD exposure (in an environment where global growth recovers, for example) could consider a EUR/MXN call (where vols are close to 10%) too.

Fig 47 Implied volatility of EUR/MXN at-the-money 6-month Calls is at Recent Historic Lows



Source: Bloomberg

Eimear Daly
+44 20 3037 4802
eimear.daly@macquarie.com

EM EMEA: Domestic Divergence

Turkish lira: Overcooked and stuffed

We continue to recommend short TRY positions as market focus on the erosion of Turkey's democracy and US sanctions risk lead to foreign investor outflow from Turkish assets. Domestic demand for USD deposits is also adding to downside pressure on TRY, reinforcing the banking sector's balance sheet weakness, which authorities appear reluctant to come to terms with.

1.) **An escalation in the erosion of democracy.** President Recep Erdogan reacted to the 2016 attempted political coup by tightening his control on the economy, in moves that increasingly eroded Turkey's democracy and conventional institutional governance. In much the same way, the ruling AK Party's defeat in the 31 March 2019 mayoral elections in Ankara and nine provincial capitals, including Istanbul, are further undermining Turkish democracy. The AK Party has requested an election re-run in the Istanbul province and Buyukcekmece and at least five pro-Kurdish mayoral candidate who won office in the elections face being barred from taking their seats by the High Election Board. Both developments would help to boost the AK Party's political control.

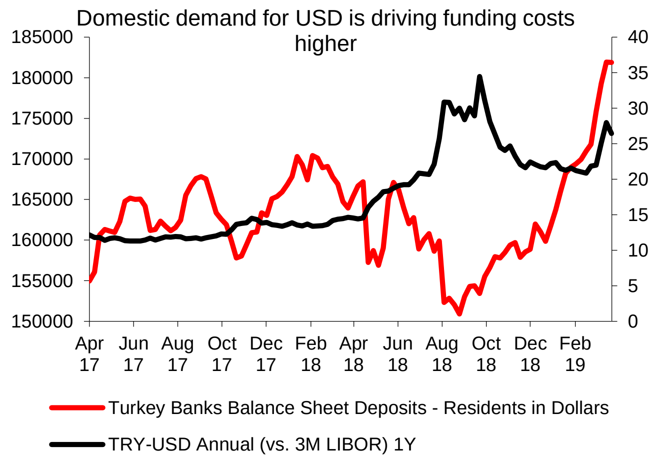
2.) **US sanctions threat**. Erdogan has stated that the purchase of the Russian S-400 missile defense system is a 'done deal'. US authorities were clear that Turkey's choice was between the Russian S-400 and Nato's F-35 Joint Strike Fighter jet program. Both economic sanctions under the Countering America's Adversaries Through Sanctions Act and Turkey's place in the NATO alliance have been threatened if delivery of the S-400 takes place. Turkey's order for the F-35 has already been suspended. Reprisal for the delivery of the S-400 should be expected, starting with some form of economic sanction and relegation of Turkey to a marginal role within the NATO alliance.

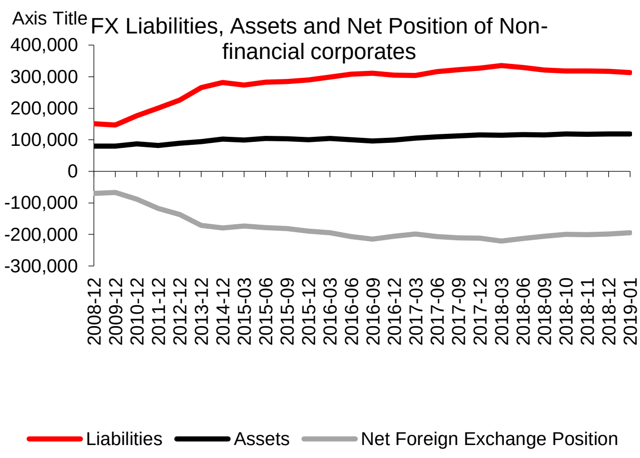
Other US sanctions are waiting in the pipeline. The Defending United States Citizens and Diplomatic Staff from Political Prosecutions Act 0f 2019 is sitting with the Committee of Foreign Relation after its introduction to the Senate on 9 April 2019. The bill includes US travel bans and the freezing any US assets for any senior Turkish officials involved in the wrongful detentions of US citizens and staff.

3.) **Banking sector on the brink** . The TRL devaluation in 2018 multiplied the TRY equivalents of FX loans, leading to increased debtor demands to restructure loans and a jump in non-performing and closely monitored loans. Turkey's economic recession increases credit risks and further adds to non-performing loans (NPL) numbers. Turkish banks face elevated domestic and foreign funding costs while government initiatives to lower credit costs through state banks create competitive pressure on private banks to lower lending rates, below that of the CBRT. The Turkish banking sector's balance sheet FX deficit is just off a historical high at TRY175mn . There is also a lack of transparency of the depth of the banking sector turmoil, with Moody's rating agency openly questioning the accuracy of the banking sector NPL ratio of only 4.1%.

4.) **The dollarisation of the domestic economy.** The devaluation and high volatility of TRY has fuelled domestic demand for dollars. Residents USD deposits reached a new record high of USD 182mn in the most recently released data on 5th April 2019. This has led to selling pressure on the TRY and pushed dollar funding costs to levels reminiscent of the August 2018 TRY currency crisis. Turkish non-financial companies have a net FX deficit of USD195bn, suggesting continued domestic selling pressure on TRY.

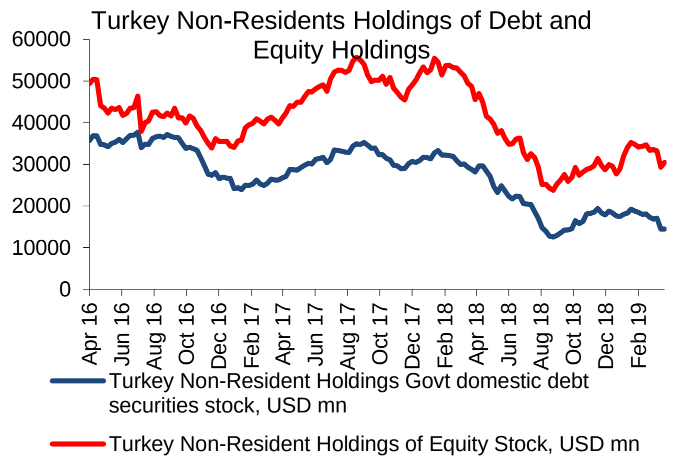
Fig 48 Resident demand for USD deposits likely to continue amid a substantial net FX deficit in the real economy

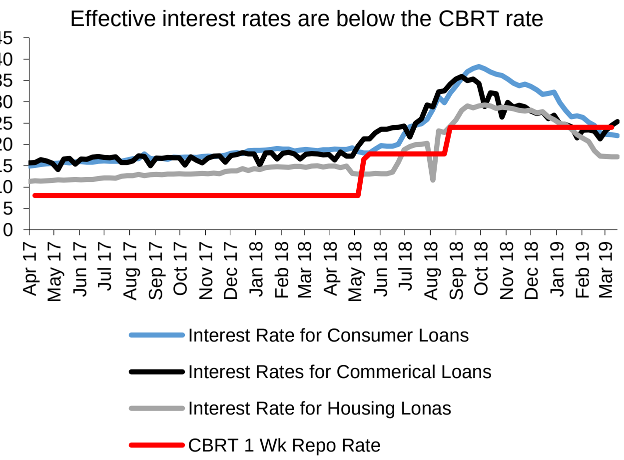




Source: CBRT, Bloomberg, Macquarie FX Strategy

Fig 49 Government policy succeeds in pushing effective interest rates below the CBRT benchmark





Source: Central Bank of Turkey, Macquarie FX Strategy

5.) **Far from reform, authorities double down on cheap credit policies to stimulate the economy.** Investors hoped Turkey's 2019 economic programme would deliver needed reforms, given the end of short term electoral cycle. While the programme pronounced substantial economic reforms, reform details were lacking and there was nothing to address the balance sheet crisis in the real economy or implement fiscal discipline. The only detailed policy was the provision of TRY28bn in government bonds to recapitalise state banks, but nothing for their private counterparts. Two new funds were promised into which banks could transfer NPL from the energy and property sectors, though it is not clear how these new assets will be priced and whether there will be any investor demand for them. The plan to boost state banks' capital also boosts their lending capacity, suggesting that the real economic plan is to keep credit flowing from state-owned banks, at the cost of the fiscal debt.

The most telling indictment of the programme was the government's policy to fight inflation. The establishment of a greenhouse company was backed by targets to increase fruit and vegetable production and raising the number of sheep and goats from 47m today from 100m in 4 years. Instead of addressing the economic weaknesses that led to the TRY crash, Turkey is internalising its economy. Increased self-reliance is a policy previously adopted by Russia and does not imply a favourable environment for foreign investors.

6.) **Foreigners sell TRY assets.** Foreigners' net selling of Turkish equity and government domestic debt since late February draws a dangerous historical parallel with financial account outflows ahead of the August 2018 currency crisis. Turkey is particularly vulnerable to shifts in foreign investor sentiment given its financial account is 99% funded by portfolio inflows, based on 6month average data. While foreign holdings of Turkish assets are much reduced from year ago levels, foreign investors' outstanding USD30.4bn in Turkish equities and USD14.5bn of government debt suggest scope for further foreign TRY asset sales if geopolitical and economic concerns escalate further. Residents' accumulation of FX deposits suggest domestic investors will also add to TRY downward pressure.

South African rand: The lights are back on

The ZAR has been one of the best performing EM currency versus the USD since 29 March after Moody's rating agency confirmed South Africa's last remaining investment grade rating and the JP Morgan Government Bond EM index increased its South African debt weighting. The moves lower in USDZAR are in line with our official forecasts.

We continue to look for further downside with an end-2019 forecasts of 13.4. This is based on four reasons:

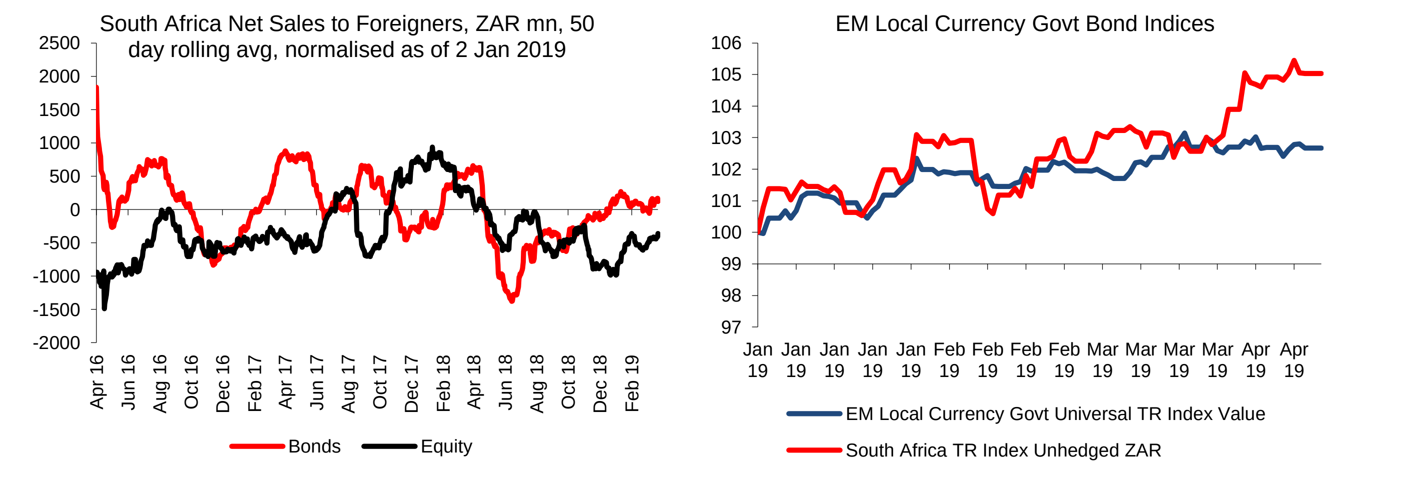
1.) **Reduced domestic risk**. The deadline for Moody's next sovereign rating review is 1 November 2019, providing the government with considerable breathing space to implement reforms. The ruling ANC party's strong polling suggests the 8 May election is not so much a political risk but a currency positive as a strong election mandate will allow the government to enact sweeping post-election reforms. While Eskom remains a financial risk, additional capacity coming online means South Africa is expected to avoid load shedding during the winter, which should keep Eskom out of market focus.

2.) **An increasingly positive environment for EM assets**. A dovish shift from the world's biggest central banks and the rising probability of a US-China trade deal has resulted in significant investor inflow into Emerging Market assests. The Bloomberg Barclays Emerging Market Local Currency Government Bonds has rallied 2.62% since the start of 2019

3.) **Positive fundamentals suggest ZAR will be one of the biggest beneficiaries of an EM rally**. Credible central bank policy, significant FX reserves, and healthy external balances suggest ZAR asset outperformance will continue. The Bloomberg Barclays South Africa Local Currency bond index has rallied 4.69% since the beginning of 2019, well outperforming its EM peers.

4.) **Positioning is clear.** While non-resident investors have increased their holding of South African Government Bonds since the start of 2019, its off a two year low, indicating that positioning is far more stretched.

Fig 50 Consistent Foreign Investor inflow into SA government debt drives outperformance versus EM peers



Source: JSE Stock Exchange, Bloomberg, Macquarie FX Strategy

RUB: The Ruble's rally faces risks

The Russian ruble has been one of the biggest beneficiaries of the positive EM environment, with significant foreign inflows into its domestic government bond market. The Russian ruble's positive attributes are obvious: positive external balances, falling government and real economy debt, minimal real economy FX exposure and substantial FX reserves. RUB offered investors carry as well as value. However, the reason why the currency's fundamentals are so favourable is reason enough to be cautious.

Risks to the RUB rally:

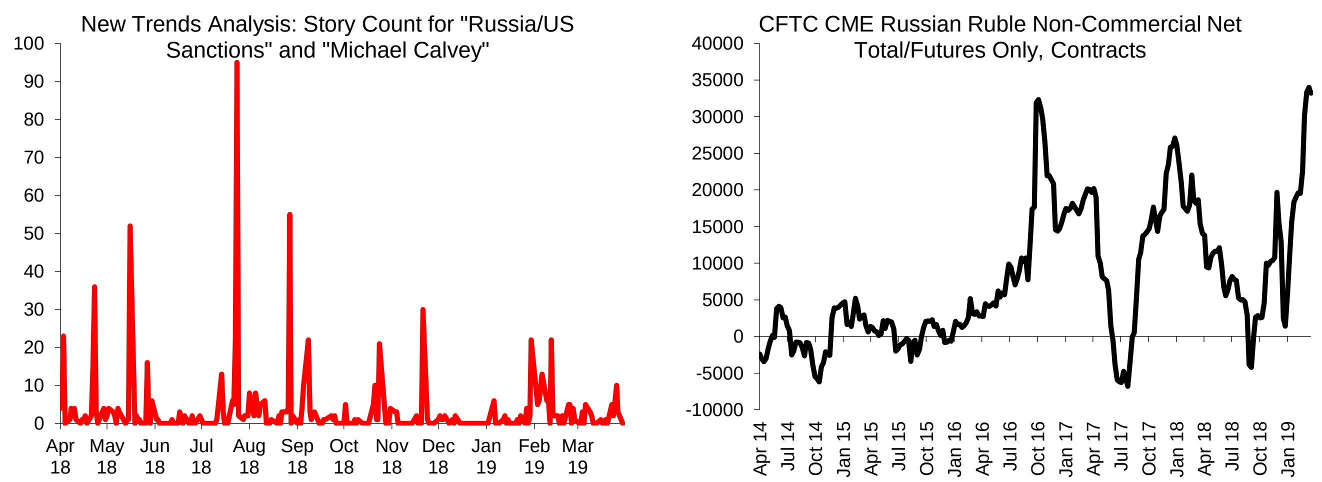
1.) **US Sanctions** have reportedly already been vetted and are currently awaiting final approval from the White House. Russia's pre-emptive measures to insulate the economy from future US sanctions is the reason behind the strong currency fundamentals. The imposition of sanctions represent an inherent risk to the currency.

2.) **Positioning is now extended.** According to CFTC data, long RUB positioning is just off a historical high. Foreign holding of Russian internal government debt (OFZ) are also approaching a record high. However, we note that foreign holdings account for only 25.9% of market share suggesting some scope for further RUB upside.

3.) **Russia's persecution of foreign investors** leaves the RUB vulnerable to headline risk. The arrest of American private equity manager Michael Calvey is a reminder of Russia's litigation history against foreign investors. The private equity manager claims the fraud charges brought against him relate to a corporate dispute with a Russian businessman with ties to the Kremlin. This will limit foreign FDI and capital inflow into Russia in the long-term.

We continue to forecast further RUB upside based on the continuation of the positive environment for EM assets. However, our shallower USDRUB trajectory reflects the fact that extended long RUB positioning will limit the currencies ability to benefit from a weaker dollar. We forecast USDRUB at 62.0 by end-2019.

Fig 51 Market Focus on Russian geopolitical risk has subsided but could quickly spike higher



Source: Bloomberg, Macquarie FX Strategy

Detailed FX Forecasts Summary

Fig 52 FX forecasts (end of period, forecasts shaded)

	Quarterly										Annual				
	18Q3	**18Q4**	**19Q1**	**19Q2**	**19Q3**	**19Q4**	**20Q1**	**20Q2**	**20Q3**	**20Q4**	**2018**	**2019**	**2020**	**2021**	**LR**
G10															
EUR USD	1.16	1.15	1.12	1.15	1.16	1.17	1.18	1.18	1.2	1.2	1.15	1.17	1.2	1.22	1.20
USD JPY	113.6	109.7	110.9	113.0	111.0	110.0	108.0	105.0	102.0	100.0	109.7	110.0	100.0	98.0	95.0
GBP USD	1.30	1.28	1.30	1.32	1.32	1.34	1.4	1.4	1.4	1.4	1.28	1.34	1.4	1.45	1.40
AUD USD	0.72	0.70	0.71	0.71	0.72	0.72	0.72	0.72	0.73	0.73	0.7	0.72	0.73	0.75	0.75
USD CAD	1.29	1.36	1.33	1.35	1.36	1.38	1.40	1.40	1.40	1.40	1.36	1.40	1.40	1.40	1.40
NZD USD	0.66	0.67	0.68	0.67	0.67	0.67	0.67	0.68	0.69	0.69	0.67	0.67	0.69	0.7	0.7
Asia															
USD CNY	6.87	6.88	6.71	6.65	6.60	6.60	6.55	6.50	6.50	6.50	6.88	6.6	6.5	6.6	6.6
USD INR	72.5	69.8	69.1	68.0	68.0	68.0	67.5	67.0	68.0	70.0	69.8	68	70	72.5	74
USD IDR	14903	14390	14241	13950	13900	13900	13850	13800	13900	14000	14390	13900	14000	14200	14500
USD KRW	1109	1116	1135	1115	1100	1100	1090	1080	1080	1080	1116	1100	1080	1070	1070
USD MYR	4.14	4.13	4.08	4.15	4.15	4.10	4.08	4.05	4.05	4.05	4.13	4.1	4.05	4.00	3.95
USD SGD	1.367	1.370	1.356	1.345	1.335	1.330	1.315	1.305	1.295	1.290	1.37	1.33	1.29	1.28	1.26
USD TWD	30.5	30.7	30.8	30.5	30.2	30.0	30.0	30.0	30.0	30.0	30.7	30	30	29.5	29
Latin America															
USD ARS	41.3	37.7	43.3	46.0	49.0	51.0	50.0	50.0	50.0	50.0	37.7	51.0	50.0	50.0	50.0
USD BRL	4.05	3.88	3.92	3.80	3.60	3.55	3.50	3.45	3.45	3.45	3.88	3.55	3.45	3.50	3.50
USD CLP	657	694	680	665	670	675	685	685	690	690	694	675	690	700	710
USD COP	2966	3255	3186	3200	3225	3250	3270	3280	3290	3290	3255	3250	3290	3300	3300
USD MXN	18.7	19.7	19.4	19.5	20.0	20.5	21.0	21.0	21.5	21.5	19.7	20.5	21.5	22.5	23.0
EMEA															
USD ZAR	14.1	14.3	14.5	13.8	13.6	13.4	12.8	12.3	12.2	12.5	14.3	13.4	12.5	13.8	15.0
USD TRY	6.06	5.29	5.57	6.20	6.00	5.80	5.00	5.25	5.40	5.10	5.29	5.00	5.10	5.50	7.28
USD RUB	65.6	69.7	65.6	63.0	62.5	62.0	61.5	63.0	61.0	62.5	69.7	63.5	62.5	66.0	72.0

Source: Bloomberg, Macquarie Strategy

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