The key G3 economies had a surprising twist in 1Q fortunes to say the least. Japan's final 1Q-2014 GDP grew faster than expected at 6.7%q/q SAAR. Japan's stellar 1Q performance puts it in sharp contrast to the US which ended on the opposite side of the growth spectrum and endured its first quarterly contraction since 1Q 2011. And while the euro-zone seemed to have emerged from recession, its sub-1% 1Q growth was really nothing to shout about.

But there are specific factors responsible for the broad divergence in 1Q performance for Japan and US, and they will not be repeated in 2H. Japan's growth spurt stems mainly from the consumption and investment surge ahead of the 1 April sales tax hike and markets should wary about the potential downslide in 2Q and 3Q GDP post-sales tax increase. Markets are pricing in a 4% contraction in 2Q, but we think it may be deeper, at -6%. For the US, the 1Q decline was squarely attributed to the extreme weather conditions the country suffered and despite the mixed picture from economic and labor indicators so far, a strong rebound is likely to be on the cards for 2Q and any bigger downward revision in 1Q could set US economy up for an even sharper rebound in 2Q GDP (which we revise up to 5% from 3.9%).

Meanwhile, the Euro-zone sub-performance is not due to one-off factors and the drag on the real economy could persist and worsen in the 2H. The German economy drove most of the expansion, while many of the regions are underperforming and even experiencing contraction in economic activities. And with the risk of deflation taking grip, that tipped scales for the European Central Bank (ECB) to deliver a new round of monetary stimulus in June, the only major central bank to do so in 2014 for now.

For Japan, we still expect additional easing from the Bank of Japan (BOJ) down the road in 2H 2014 although market opinion is shifting towards expecting the BOJ will not make any addition to the stimulus (announced in April 2013) after holding its hand for more than a year. The crux of the issue for Japan is the deeper than expected slowdown in 2Q and 3Q GDP post-sales tax increase. And even as PM Abe reloads and readies to fire his third arrow (again) this June, he must at least hit some of the targets (such as lower corporate tax, and redeploying the government US$1.3trn pension fund) to give BOJ reason to assist the government in helping the economy to chug along with more stimulus.

The issue for the Eurozone is more complex. As we mentioned, the ECB is only major central bank to do more monetary easing in 2014, but it has been resistant to quantitative easing (QE). So the trillion dollar question is will the ECB go there (as did BOJ, FOMC and BOE)? Draghi's comments after presenting the June package that "we aren't finished here"
clearly indicates QE is on the table. But we believe the ECB will first want some time to assess how the new measures work. Draghi will also have to overcome German resistance if he wants to do more and past behaviour demonstrates that the hurdle for QE are higher in the Eurozone than elsewhere, especially when there is little left in the ECB’s armoury (except for QE) to try to steer the Eurozone away from the economic quicksand of deflation. So overall, it is not clear whether the ECB will do QE in 2H this year.

FX Outlook: Currency Implication Is Clear But Timing Is Tricky

The British pound is the perfect recent example to show the impact of monetary policy on FX. The surge in the GBP against the USD in June was noteworthy after BOE Governor Mark Carney delivered a more hawkish than expected annual address to bankers at the Mansion House in London on 12 June. He said, “There’s already great speculation about the exact timing of the first rate hike and this decision is becoming more balanced...It could happen sooner than markets currently expect.” The pound surged against the dollar following the Carney comments and the GBP/USD pair hovered around 1.7 since (as of 19 June 2014), a level not seen after August 2009.

Conversely, as we still believe that the BOJ will expand monetary stimulus in 2014, we thus still expect the JPY to turn weaker in 2014. However, as we now expect the BOJ to act only in 3Q-14 and thus, we have revised our yen near-term forecast with the USD/JPY pair likely to reach 105 by end-3Q. We still expect the USD/JPY to breach 110 by year-end on the back of the 2H new monetary stimulus.

We still believe in our USD strength call against major and Asian FX but it has been delayed as the market fully priced in the QE taper and eased back on Fed’s interest rate hike timeline. Significant US dollar strength will only materialize when the Fed gives a concrete rate hike timeline or due to extreme geo-political risks. For now, we see the USD caught in range trading, but the bias is still for stronger USD once rate hike expectations form in later this year.

The euro has come off its 2014 highs after the June ECB easing package. Since the highs of 1.3993 in May, the EUR/USD pair has since softened tremendously, and is currently just above the 1.3500-figure. But for it to go below 1.35, the markets need to see more from ECB and that will need to be QE. So unlessQE is delivered to Eurozone, we stick to our view that the EUR/USD will likely trade around the 1.3500-levels in the second half of this year. The Euro will move lower into 2015, but this is mainly due to the stronger US dollar as we firm up the timeline for the Fed rate hike cycle for next year.