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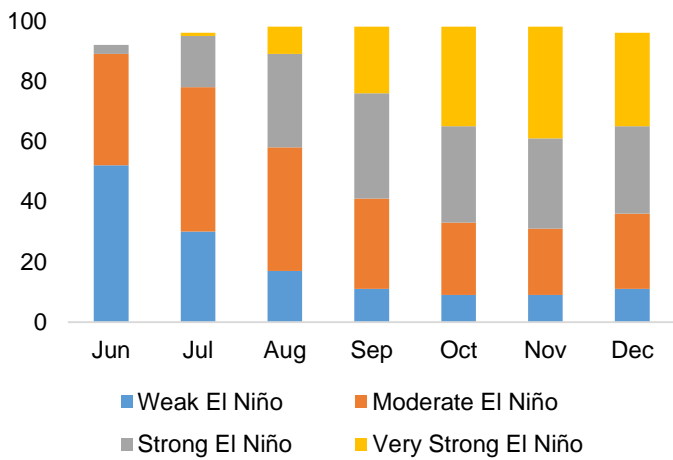
No Escape from Storm

- The U.S. Climate Prediction Centre's latest projections indicate an approximately 2-in-3 chance of strong/very strong El Niño conditions developing during the second half of 2026.
- Rainstorms and flooding could disrupt field access and reduce crushing days for farmers. Compared to normal years, a 1.5 percentage point cutback in Mainland farm output growth was seen as very strong El Niño took hold. If this coming El Niño resembles the last two events, we calculate that the impact on China's CPI could amount to 0.3 percentage point.
- El Niño can also take about 0.7 percentage point off China's GDP.
- This is not the only window El Niño comes though. Zika virus was defined as a global epidemic in 2015-16. The outbreak of infectious diseases is an escalating concern.

Economists are often teased that the job of meteorologists is to make economists feel better about their forecasts. This joke feels particularly salient this summer. The U.S. Climate Prediction Centre's latest projections indicate an approximately 2-in-3 chance of strong/very strong El Niño conditions developing during the second half of 2026. Meteorology is set to become fashionable again.

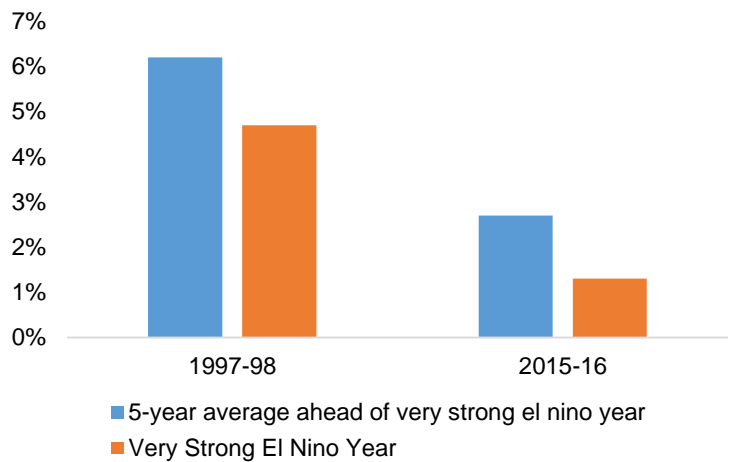
For a start, not all El Niños are created equal. El Niño intensity is measured by Oceanic Niño Index. 2026 is likely to reach rarely strong El Niño conditions, where water temperature in the Eastern Pacific rises more than 2°C (Exhibit 1). It would only be the second time in the 21st century witnessing a very strong El Niño, a shock big enough to intrude on trader’s mind.

Exhibit 1: El Niño Strength Probabilities (%)



Source: USCPC, Shanghai Commercial Bank

Exhibit 2: China’s Agriculture Production (% YoY)



Source: FAO, Shanghai Commercial Bank

In the past four decades, there have been two episodes of very strong El Niño years: 1997-98 and 2015-16. The heat wave is more than a little irritating. The Pacific hurricane season saw 16 hurricanes in each of 2014 and 2015, the joint highest number on record. Rainstorms and flooding could disrupt field access and reduce crushing days for farmers. Compared to normal years, a 1.5 percentage point cutback in Mainland farm output growth was seen as El Niño took hold (Exhibit 2). Food prices make up around 17.2% of the Chinese consumer basket. If this coming El Niño resembles the last two events, we calculate that the impact on China’s CPI could amount to 0.3 percentage point.

The heat gnaws at whatever growth remains. A 1°C increase in temperature is generally believed to siphon 1-3% productivity away manufacturing plant. If it unfolds, El Niño will take about 0.7 percentage off China’s GDP.



This is not the only window El Niño comes through. Setting the stage with the post-disaster poor hygiene conditions or undernutrition, Zika virus was defined as a global epidemic in 2015-16. Looking much further back to 1997-98, there was an outbreak of Rift Valley fever in Kenya, Somalia and Tanzania. Viral outbreak is becoming the norm rather than merely a passing phase.

The climate risk statement often looks like the lowest line of the Snellen chart in your optometrist's office. Ignorance isn't always bliss. What does seem clear is that trader will spend the second half looking over their shoulders.

UK

Political instability remains the market's top concern. Reports suggest that Keir Starmer plans to tell ministers to quit if they back other rival in the leadership contest, a move that could severely undermine the government's governing effectiveness.

EU

The ECB's chief economist signals that even as energy prices fall, second-round effects will linger. Any post-meeting comments on energy pass-through will shape market expectations for the future ECB rate path.

Japan

The yen stays soft even as the Nikkei reports a planned BoJ rate hike in June. Pressured by the administration, the BoJ is much less sensitive to inflation than Western central banks. A prolonged Middle East deadlock would only widen the G7-Japan rate gap further, weighing on the yen.





US

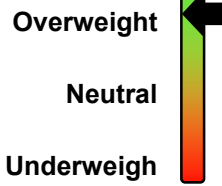
Strong employment data are cementing rate hike expectations while eroding Warsh's rationale for a rate cut. All eyes will be on Warsh's debut press conference, as any excessively dovish signal could revive doubts about the Fed's independence.

Chinese Mainland

Chinese equities continue to trail global markets and the property market remains sluggish. The lack of wealth effects and subdued public confidence have left domestic consumption struggling to pick up. Exports will therefore remain the main engine of China's economic growth.

Foreign Exchange Outlook

<p>USD</p> 	<p>Overweight Neutral Underweight</p> 	<p>The dollar continues to edge higher as labour data generally surprises on the upside, and the traders re-consider the possibility of a Fed hike this year. So far, Mr. Market has rewarded the perceived disruptors and punished the perceived disrupted. The greenback could test the top of the short-term trading range this summer.</p>
<p>EUR</p> 	<p>Overweight Neutral Underweight</p> 	<p>European corporates seem to have passed on input price increases quicker this year than they had in 2022. Any bigger-than-expected oil inventories drawdown would weigh on the euro.</p>
<p>GBP</p> 	<p>Overweight Neutral Underweight</p> 	<p>Burnham's bid to Labour leadership could thus prove key for the outlook of the GBP. Following the seasonal end of overseas profit repatriation, a Burnham premiership would entail greater downside risks for the pound, if fiscal discipline is not addressed early on.</p>
<p>RMB</p> 	<p>Overweight Neutral Underweight</p> 	<p>USDCNY finally broke below 6.80, the first time since February 2023. FX conversions by exporters were phenomenal. This is not a trend that PBoC is entirely comfortable with, as evidenced by the weaker-than-expected fixings. Be mindful of the negative carry driven selling flows.</p>
<p>JPY</p> 	<p>Overweight Neutral Underweight</p> 	<p>The BoJ undertook JPY11.8 trillion of FX intervention last month, but the yen has already slipped back to its pre-intervention level. Ueda's recent speech did not hint a back-to-back hikes or 50bp move. The potential rebalancing flows driven by pension fund's stocks gain and continued NISA-relation equity outflows continue to dampen the yen, though the yards will likely be harder.</p>
<p>AUD</p> 	<p>Overweight Neutral Underweight</p> 	<p>The Aussie has had a great run. The fiscal reform is expected to boost Australia's woeful productivity trajectory and take some pressure off the RBA to raise rates further. Overall, it feels like the bias is to shift more commodity ownership.</p>



AUD/NZD has been trading at the highest level since early 2013. Any pullback in equity could dent the appeal of the high-beta currency however.

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