Economics & Strategy Weekly

Asian FX: Rising volatility and vulnerability

DBS Group Research

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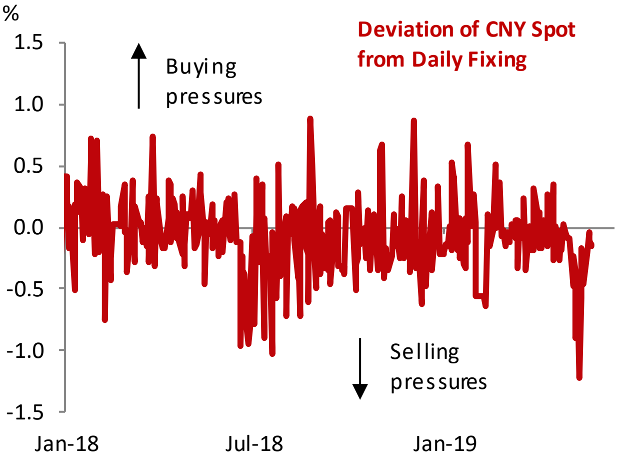
- *Trade war is intensifying and broadening, and regional currencies are facing the brunt of the rise in uncertainty and downside risks*
- *The dollar index, up 6.5% since the beginning of last year, could rise further against the backdrop of economic and political uncertainty in EU, slowdown in China, and security risks in the Middle East.*
- *Asian currencies with heavy external funding needs could struggle in this climate.*
- *In India, the ruling coalition staying on for a second term with an emphatic majority underscores policy continuity and stable political environment for the next five years.*
- *Japan's latest growth numbers may have been better than expected, but ongoing trade wars and looming Upper House elections could weaken the resolve for the long-awaited VAT hike.*

Trade wars take their toll on regional currencies

The worrisome escalation in trade wars is causing global investment and trade momentum to weaken, but even before data related to those activities become available, currency markets have been reflecting the rising gloom and uncertainty.

China, facing one salvo after another from the US on a nearly daily basis, has seen a sharp rise in CNY volatility. Some intervention in the in off-shore market may have arrested the volatility in the last few days, but it is natural for the currency to sell off as the export sector faces a myriad of shocks, ranging from tariffs to severe restriction to US markets for high tech industrial inputs. Registering a 3% slide against the USD in the past month, the CNY is primed to head toward 7 in the coming days as hope for a trade war truce fades and China's growth momentum weakens.

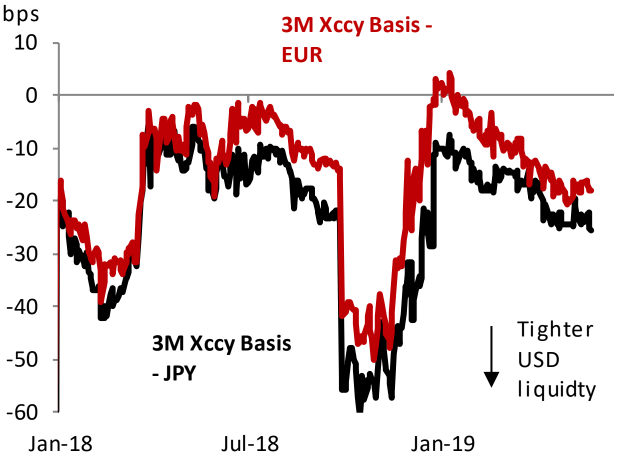
Measure of CNY stress



Source: Bloomberg

Since the US Fed monetary policy about-turn in late December, global liquidity conditions had eased, but the renewed escalation in trade tensions has begun to erode those gains. Measures of USD funding conditions show a steady tightening in recent months. As the markets face tighter USD liquidity despite an accommodative Fed, financial conditions will invariably tighten. This may cause for further demands for the Fed to cut interest rates, but until that happens (and we think it is unlikely to happen any time soon, unless global markets sell off sharply and in a disorderly manner), we will expect sustained USD strength against both EM and DM currencies.

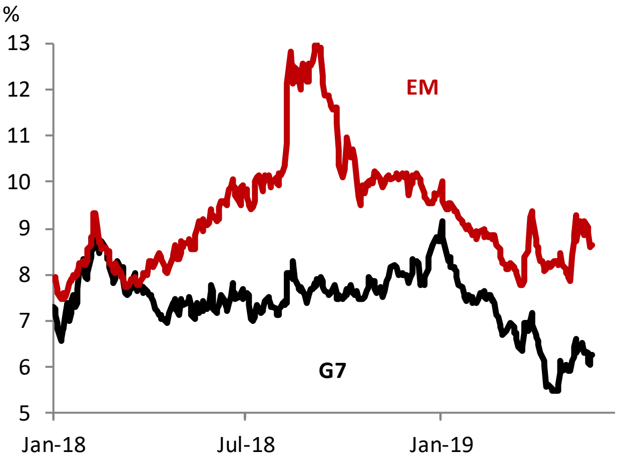
Tightness of USD Funding - Secured



Source: Bloomberg

As seen in the following chart, currency volatility has begun to rise, although vols are nowhere close to what was seen last summer. The path ahead is one of higher volatility, in our view, as on-again-off-again developments in trade negotiations, Brexit, Iran, and US politics keep the markets lurching from one direction to the other. Currencies of the UK, Turkey, and Argentina have idiosyncratic reasons for selling off, but a broader narrative to depreciating against the USD has emerged, in our view. As long as the US remains hyper assertive in foreign and trade policies, and domestic economic momentum remains broadly unchanged, the dollar-favourable environment is unlikely to shift.

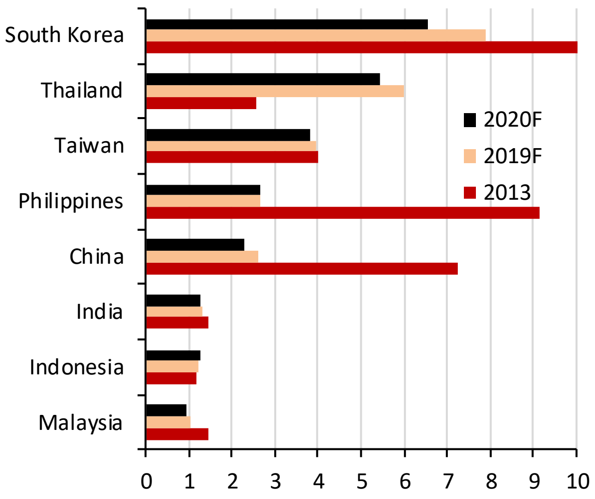
Currency Vols (Implied)



Source: Bloomberg

Here in Asia, there is quite a bit of vulnerability with respect to external financing. Below we update our funding gap calculations. Our favoured metric is gross external funding, which is the sum of current account balance forecast and all hard currency debts due in a given year. The ratio of central bank FX reserves to gross external funding needs is therefore a useful gauge of currency vulnerability.

Reserves to Gross External Funding



Sources: National authorities, CEIC, and DBS

Updating our calculations for 2019, we find that funding cover has generally declined in the region, one exception being Thailand. Although South Korea, the Philippines, and China have sizeable cover for externa debt, their ratios have nonetheless fallen markedly in recent years.

India, Indonesia, and Malaysia's currencies are the most vulnerable, by this metric, and have remained so despite some build up in reserves in recent years. We will keep our eyes on these three currencies, plus the CNY, during the course of what is likely to be a summer of discontent.

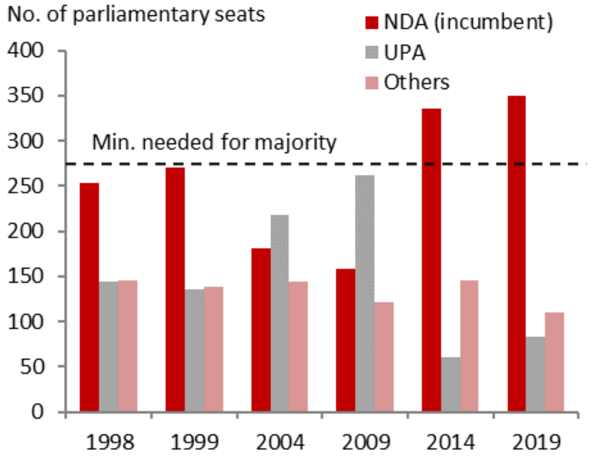
Taimur Baig and Duncan Tan

India: Decisive win for India's ruling coalition

The incumbent National Democratic Alliance (NDA)-led by the Bharatiya Janata Party (BJP) returned to power with a clear majority, outdoing the average exit poll. Staying on for a second term with an emphatic majority underscores policy continuity and stable political environment for the next five years.

Election results

No. of parliamentary seats



Alliance parties - tally in key states

Poll	NDA (BJP-led alliance)	UPA (INC led alliance)	Others
Uttar Pradesh	63	1	16
Maharashtra	41	5	2
Bihar	39	1	0
West Bengal	18	3	21
M.Pradesh	28	1	0
Rajasthan	25	0	0
Tamil Nadu	1	32	6
Karnataka	25	1	2
Gujarat	26	0	0
A.Pradesh	0	0	25

Source: Election Commission, press, DBS Group Research Count as on May 24, 0155GMT

Domestic markets extended the relief rally that started on Monday as actual results turned out to be better than exit polls and another five years of political stability looks imminent. While unable to skirt weak global risk sentiments, Indian markets might fare better on relative basis vs those most exposed to the fallout of the US-China trade tensions, especially North Asian currencies.

Down to the to-do list: With a key event risk out of the way, return of the incumbent government is business-as-usual for the economy and ticks a key box of political stability. Attention here on will return to the to-do list, key amongst which is the need to address the ongoing cyclical slowdown in growth. GDP data for the March 2019 quarter is due in late-May and is likely to see growth slip to 6.2-6.4% from 6.6% in 4Q18. The key engine of growth i.e. consumption has weakened in rural and urban areas as lead indicators suggest (auto sales, non-durable production etc.). Job creation has progressed at a slower than desired pace, weighing on discretionary spending; these areas are likely to gain priority under the government's second term. Manufacturing activity has also felt the heat from slowing consumption, and a challenging global demand/ trade outlook.

On reforms, impetus to iron out and improve the implementation of GST, financial inclusion, infra spending, banking sector efforts etc. will continue. India's political-economy has also attained modern welfare dimensions-direct cash transfer, health insurance, crop support prices, pension for unorganised sector workers etc. Consolidation of these support schemes into a welfare construct, will help boost purchasing power of agri-dependent and lower income families.

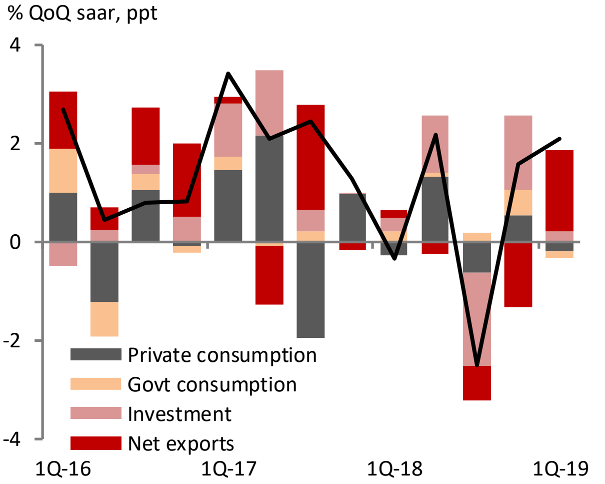
Beyond elections, two other aspects will be watched with interest. Full-year Budget in June/July and RBI rate review in June. The goal of narrowing the fiscal deficit to 3% of GDP for the centre continues to be delayed, with the February Interim Budget already making room for a small slippage in the fiscal goals. An additional ~10bp slippage in the fiscal deficit target might be on the cards at the full-year (June/ July) Budget. For the RBI, we continue to expect a 25bp cut in June, but will be a close decision due to global uncertainties, lack of clarity on monsoon and higher oil prices. If undertaken, this is likely to mark the late end cutting cycle as inflation prints are off January 2019 lows. Addressing the liquidity squeeze in the domestic credit markets will be the central bank's priority, to transmit lower funding costs, along with supporting non-bank entities.

Radhika Rao

Japan: Risks beneath 1Q GDP figures

The Japanese economy surprised on the upside in 1Q, with real GDP posting an unexpectedly strong growth of 2.1% QoQ saar (consensus: -0.2%). There is nothing to cheer about, for three reasons. First, the 1Q GDP rise was largely attributed to the sharp decline in imports (-17.2%) that outpaced exports (-9.4%). Net exports turned positive for the first time over four quarters, contributing as much as 1.6ppt to the headline growth in 1Q. Private consumption and government consumption both shrank in 1Q (-0.3%, -0.7%), while investment growth decelerated notably (0.9% vs 6.5% in 4Q18).

Japan: GDP growth rose in 1Q on net exports



Secondly, a downward revision in 1Q GDP remains possible when the final estimate is released in mid-June. Past experiences showed that the preliminary and the final GDP estimates could be very different. In the previous eight quarters ending 4Q18, the discrepancy between the two figures was as much as 1ppt on average.

Thirdly, a 2Q growth pullback appears likely. Manufacturing PMI dipped again in May (flash: 49.6) after a temporary rebound in April. The subcomponent of export orders deteriorated the most, probably reflecting China's economic slowdown and importantly, the recent escalation in China-US trade war/tech war.

Our 2019 GDP forecast is kept unchanged at 0.7% for the time being, with risks clearly skewed to the downside. We will review our forecast after collecting the final 1Q GDP data and more high-frequency indicators for 2Q.

Higher China-US trade tensions could weigh on Japan's growth outlook through multiple channels, including disrupting the regional electronics supply chains, delaying the 5G launch and dampening the related tech demand, as well as weakening risk appetite in the global financial markets and putting appreciation pressure on the yen. We believe that Japan is less vulnerable than Taiwan and South Korea to the risk of supply chain disruption, because its exposure to electronics exports is relatively small. That said, given the potential double-whammy impact (both on supply chain and financial markets) and the fact that Japan's GDP growth is low to start with, we think **recession risks will increase in the event of a full-blown China-US trade war.**

Policy implications

The government will raise consumption tax to 10% from 8% this October as currently planned, under the base case scenario. Abe has repeatedly said that tax hike will proceed, unless Japan is hit by a shock like the scale of the 2008 global financial crisis. This, however, does not mean a tax hike delay is impossible. Note that there have been precedents for Japan to delay the planned consumption tax hike in recent years (2014, 2016), even in absence of a crisis-style economic shock. **Should the China-US trade war escalate, recession risks increase,** and Abe's approval ratings suffer ahead of the July upper house election, **there would be enough justifications for the government to postpone the tax hike.**

The Bank of Japan has strengthened the forward guidance on monetary policy at the latest April meeting, pledging to maintain the extremely low levels of short- and long-term interest rates for an extended period, at least through "around spring 2020". This supports our view that **the policy-balance rate and the 10-year yield target will be kept unchanged through this and next year**, at -0.1% and 0%, respectively. **In the event of trade war escalation and a rise in recession/deflation risks, it won't be surprising to see the BOJ take extra actions.** Policy tweaking is more likely than comprehensive easing, in our view, given policymakers' concerns about the side-effects of negative interest rates/flat yield curve.

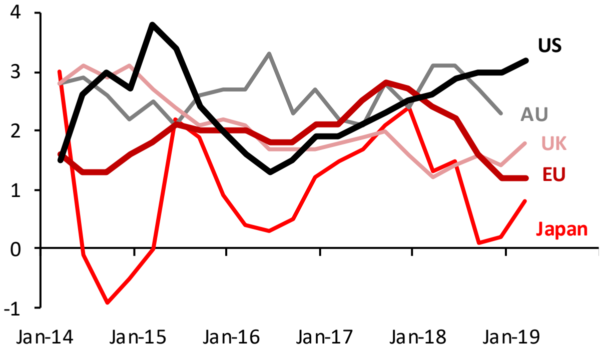
Ma Tieying

FX: The return of King USD

In the game of currencies, don't think about dethroning the US dollar, at least not now. The greenback is underpinned by America having the best economic growth and highest interest rates in Developed Markets. Renewed US-China trade tensions are not expected to lead to a world recession, but they have punctured optimism for a meaningful second half recovery. The resilient US economy has provided the Fed reason to consider the recent inflation weakness as temporary, and hence, no urgency to move US rates in either direction. **Thus, the Fed hike pause is no longer holding back the ascent of the USD Index (DXY) towards 100.**

US growth has overtaken its Developed Market peers

Real GDP growth, % YoY

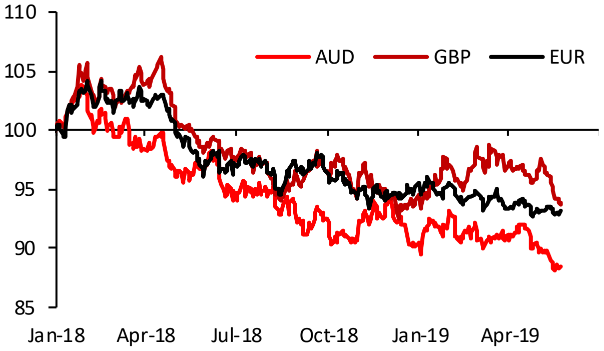


Sources: DBS Research, Bloomberg data

Instead, other central banks are more likely to cut rates first. For example, the Reserve Bank of Australia is set to lower its cash rates on June 4. Australia's unemployment rate has risen to an 8-month high in April. The RBA expects growth to fall, for the first time since the global financial crisis, below 2% in 1H19. Hence, the Oz could return to its 0.63 low in 2009, especially now that the key support at 0.70 has been taken out.

The sell-off continues in the AUD, EUR and GBP

% change vs USD since start of 2018



Sources: DBS Research, Bloomberg data

The euro could head below 1.10 if Euroskeptics secure more than a third (250) of the 751 MEP seats being contested at the European Parliament elections on May 23-26. Populist and far-right parties are seeking to increase representation in the European Parliament to exert more influence in reshaping the bloc. Pay attention to the three EU countries contesting the most MEP seats – Germany (96 seats), France (74) and Italy (73). In Italy, a strong showing for Matteo Salvini could widen the rift between his far-right Lega party and its left-leaning coalition partner, the Five Star Movement. The vote in France is considered a referendum on President Emmanuel Macron and a vehicle for far-right leader Marine Le Pen's comeback. In Germany, the election will measure CDU Leader Angela Kramp-Karrenbauer's credentials as Angela Merkel's successor.

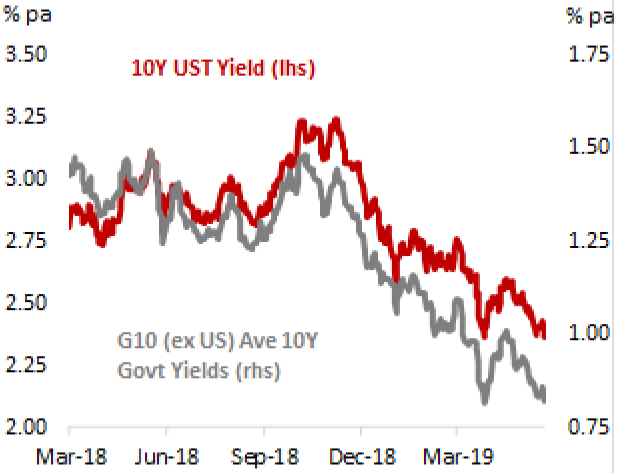
The British pound is also beset by political uncertainties. British Prime Minister Theresa May's spokesman was not aware of any plans to announce her resignation today. Foreign Secretary Jeremy Hunt affirmed that Mrs May will be prime minister during US President Trump's visit to Britain on June 3-5. Hunt was also the first cabinet minister to tell Mrs May to abandon her doomed withdrawal agreement. Instead of publishing her Brexit bill today, Mrs May could announce her exit from No. 10, possibly on June 10. Money managers do not view, Boris Johnson, the top contender to succeed Mrs May, as positive for the pound. Neither do they favour Labour Party leader Jeremy Corbyn as prime minister. Increasingly, a no-deal Brexit has become the legal default outcome on October 31. The lows for GBPUSD was 1.25 during the political leadership challenge faced by Mrs May last December, and 1.20 after the Brexit referendum in June.

Philip Wee

Rates: Downside risks in focus as US yields tumble

10Y UST yields broke technical support at 2.36%, setting the stage for further downside in the immediate term. With China-US trade tensions simmering and US equities threatening a more serious wobble, the path of least resistance for US yields is to the downside. US Treasuries are also supported by the relentless push lower in developed market yields. Since the start of the year, DM yields (average of G10 excluding the US) have fallen by 31bps with 10Y German yields drifting below -0.1%. Aside from trade tensions, weak Eurozone economic numbers and Brexit risks have also supported DM govvies.

US yields getting dragged lower



Source: Bloomberg

In the short term, without any respite from the negative trade war narrative, US yields are likely to be held down. This premium in Treasuries could linger for an extended period even if the Fed does not cut rates. The technical setup for 10Y yields point to another 20bps of downside. However, we are wary chasing yields lower. Notably, yields at these levels already look stretched to the downside given US economic fundamentals and the significant Fed easing (3 cuts over the next two years) that the rates space is already pricing in.

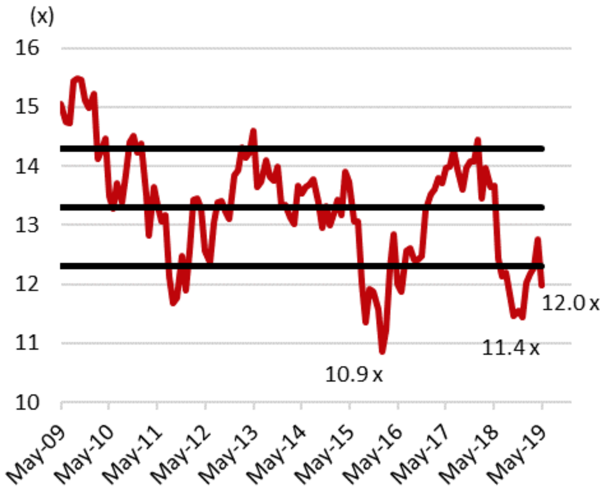
Eugene Leow

Equities: Singapore's resilience amid trade war blues

Given the ongoing hostility between China and US over trade and tech issues, the Singapore market is unlikely to be spared from volatility and portends downside risks in the coming weeks.

We however think the downside is less than 10% as there are many factors supporting the market. Following the recent correction, **Singapore is now the cheapest market within Asia, trading at less than -1SD away from average, and has the highest dividend yield.**

Singapore 12-month forward PE



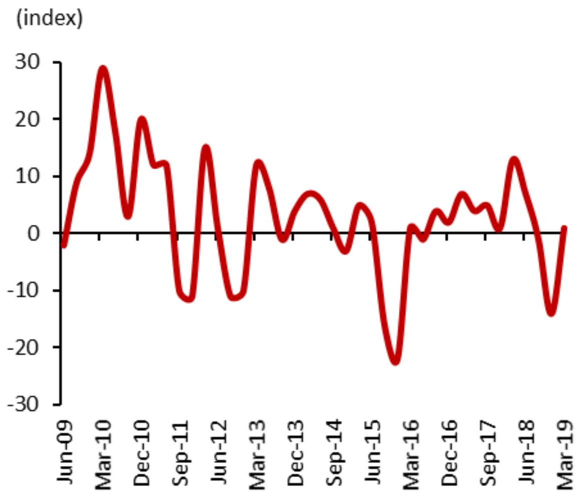
Source: IBES, Thomson Reuters, DBS

Our calculations show that there will be 10% and 4% downside respectively if the markets were to test both the low valuations of 2016 and 2018. The 2016 market selloff was due to the Brexit referendum while the trade war grabbed headlines in 2018. These two niggling worries are still simmering at this point but we think the market has priced in most of the negatives, unless they get worse.

Investors can also find comfort in an environment where expectations are a lot lower than last year before the trade war threats surfaced. In March last year, business expectations for manufacturing activities were the strongest but had since collapsed to a low point by the end of the year. It has picked up slightly recently but not to exuberant levels.

Meanwhile, we think the trade war could give rise to **opportunities for ASEAN countries to capture some of the trade diversion and manufacturing diversification** from China. Singapore, being an ASEAN regional hub, should benefit from some of these activities.

Singapore business expectations survey: Manufacturing outlook for the next six months



Source: IBES, Thomson Reuters, DBS

We believe we are at the top of the interest rate cycle in the near term with possible rate cuts should the downturn worsen. The liquidity environment in Asia should be better compared to last year when the Fed was still hiking interest rates and on "auto-pilot" mode, versus "neutral" and data-watching approaches currently. Asia bonds and currencies should see less pressure from outflows and central banks should have the flexibility to cut rates if the global environment worsens.

Singapore should still be deemed as fairly defensive among Asian countries with its sustainable long-term growth policies and attractive valuations. Stocks with lower valuations, higher dividend yields, domestic demand and stronger earnings visibility should be cushioned from the downside risk.

Joanne Goh

Highlights of the week:

Decisive win for India’s ruling coalition
China chart book – Shadow of an escalating trade war
SGD rates: Tight liquidity
Eurozone: Politics over economics
Advantage ruling coalition, as per India’s exit polls
Recalibrating Singapore’s GDP outlook
Chart of the Week: Gauging the trade war vulnerability of Asian economies

Key Forecasts

	GDP growth, % YoY				CPI inflation, % YoY, ave			
	2017	2018	2019f	2020f	2017	2018	2019f	2020f
China	6.9	6.6	6.2	6.0	1.6	2.1	2.3	2.3
Hong Kong	3.8	3.3	2.5	2.0	1.5	2.5	2.7	2.5
India*	8.2	7.2	7.0	7.0	4.5	3.6	3.4	3.8
Indonesia	5.1	5.2	5.2	5.1	3.8	3.2	3.6	3.6
Malaysia	5.9	4.7	4.5	4.2	3.8	1.0	1.7	1.6
Philippines**	6.7	6.2	6.1	6.1	2.9	5.2	3.1	3.1
Singapore	3.9	3.2	2.1	2.5	0.6	0.4	1.1	1.5
South Korea	3.1	2.7	2.1	2.4	1.9	1.5	1.1	1.5
Taiwan	3.1	2.6	1.9	1.8	0.6	1.3	0.7	1.0
Thailand	3.3	4.1	3.8	4.0	0.7	1.1	1.0	1.3
Vietnam	6.8	7.1	6.6	6.3	3.5	3.5	3.8	3.4
Eurozone	2.5	1.9	1.2	1.5	1.5	1.8	1.2	1.3
Japan	1.9	0.7	0.7	0.5	0.5	1.0	1.1	1.6
United States***	2.3	2.9	2.5	1.5	2.1	2.4	1.7	1.6

* refers to year ending March ** new CPI series *** eop for CPI inflation

	Policy interest rates, eop							
	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
China*	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	6.25	5.75	5.75	5.75	5.75	5.75	5.75	5.75
Indonesia	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
Malaysia	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Philippines	4.75	4.50	4.25	4.25	4.25	4.25	4.25	4.25
Singapore**	1.95	1.95	1.95	1.95	1.95	1.95	1.95	1.95
South Korea	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.50
Taiwan	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
Thailand	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Vietnam***	6.25	6.25	6.25	6.25	6.00	5.75	5.75	5.75
Eurozone	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
United States	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50

* 1-yr lending rate; ** 3M SOR ; *** prime rate

	Exchange rates, eop							
	Mar 29	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20
USD/CNY	6.71	6.85	7.00	6.95	6.90	6.85	6.80	6.75
USD/HKD	7.85	7.85	7.85	7.84	7.83	7.82	7.81	7.80
USD/INR	69.2	70.0	71.0	71.5	71.0	70.5	70.0	69.5
USD/IDR	14243	14300	14500	14400	14300	14200	14100	14000
USD/MYR	4.08	4.10	4.20	4.25	4.20	4.15	4.10	4.05
USD/PHP	52.6	54.0	55.0	54.5	54.0	53.5	53.0	52.5
USD/SGD	1.36	1.37	1.40	1.39	1.38	1.37	1.36	1.35
USD/KRW	1135	1170	1180	1170	1165	1160	1155	1150
USD/THB	31.7	32.5	33.0	32.8	32.6	32.4	32.2	32.0
USD/VND	23189	23250	23300	23280	23300	23250	23200	23150
AUD/USD	0.71	0.70	0.68	0.68	0.68	0.69	0.70	0.71
EUR/USD	1.12	1.12	1.10	1.11	1.12	1.13	1.14	1.15
USD/JPY	111	113	115	114	113	112	111	110
GBP/USD	1.30	1.30	1.28	1.29	1.30	1.31	1.32	1.33

Australia, Eurozone and United Kingdom are direct quotes

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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