Macro | FX Research and Strategy

Global

FX Insight

The Transitory Risks of Inflection Points for Asian FX

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Core inflation for most of developed world have eased discernibly enough for respective central banks to become less committed to rate hikes at subsequent meetings (Fed, ECB, BoE). That said, rate cuts are anything but certain. Apart from residual tightening risks, what most central banks have in common is the desire to keep current policy settings unchanged until inflation is closer to their respective target mandates. **The Fed is no different but we detect transitory risks for Asian FX given current state of macro environment and market positioning that could force (US and Asian) inflection points to become less synchronized.**

(1) The "Fed-is-Done" is base case for majority of market participants. **That limits room for USD downside even if the Fed provides a clearer signal of an extended pause.**

(2) Fed fund futures suggest that market expects Fed to cut 130bps in 2024. Current market pricing leaves ample room for market positioning to swing towards less aggressive bets on Fed's rate cut trajectory **if the US economy prove more resilient than expected.** This is especially so with the confluence of recent events (drone attack on Russian oil tanker, industrial action in Australia's LNG plants, El Nino), that seem to have lifted commodity prices (oil, LNG, food) from year lows. While a significant commodity price rally like what we have seen in 2022 is unlikely as weakening global demand continues to provide offset for supply-induced price gains, a gradual recovery in commodity prices could be enough to raise inflation expectations and policy makers, **most notably the Fed, to keep rates on hold, at elevated levels for longer.** While this is not our base case, such ***concerns*** **could keep Asian FX under pressure.**

(3) Bear-steepening of the UST curve would entail a rise in UST 10y yield that is typically negative for regional currencies. High-yielding regional currencies such as the INR, IDR are most notably affected in past episodes of bear steepener as yield differential (vis a vis the US) narrow and carry trades unwind. Funding currency JPY would also be under pressure. **That said, we see this as transitory risks.**

(4) Asian currencies could come under even more pressure as market start to position for rate cuts in the region with inflation in this part of the world (apart from Singapore) trending towards the targets of many central banks.

With commodity prices seeing some uptick, we see room for AUD, MYR and CAD to outperform INR, IDR, JPY that typically underperform when UST 10y yield rise.

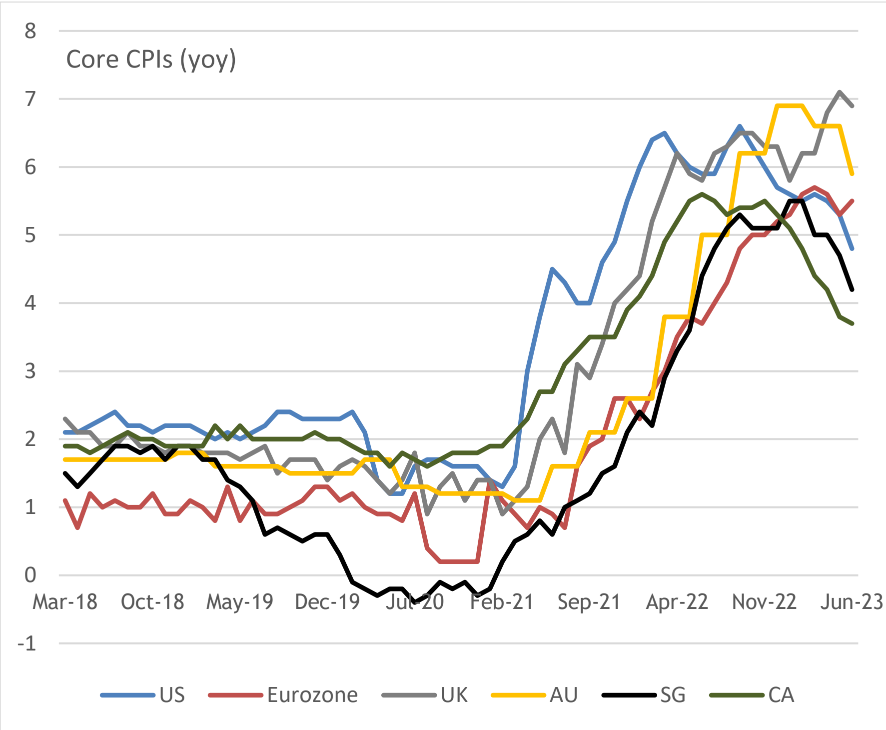
In an environment of an extended pause for Fed policy rate, we see a risk for real rates to rise as inflation continues to ease. Policy becomes restrictive even as Fed does not continue to hike. An environment of rising real rates could be negative for **gold.**

Timing of Inflection Points Matter

Easing core inflation, Albeit Sticky Allows Policy Cycles To Potentially Crest

Core inflation for most of developed world have eased discernibly enough for respective central banks to become less committed to rate hikes at subsequent meetings (Fed, ECB, BoE). Next policy decisions are now potentially a coin toss between a pause or a hike. Most policymakers expressed desire to remain vigilant on inflation trends whilst noting that monetary policy transmissions may take more time to work through the economies. In the case of BoE, there is even an acknowledgement that the central bank could be at risk of doing too much (tightening). One thing is for sure, central banks desire to keep current policy settings until inflation is closer to their respective target mandates. The Fed is no different but we detect transitory risks for Asian FX given current state of macro environment and market positioning that could force (US and Asian) inflection points to become less synchronized.

Chart 1: Core Inflation Has Been Easing Across the World



Source: US BLS, Eurostat, UK Office for National Statistics, ABS, MAS, STCA-Statistics Canada, Bloomberg, Maybank GM FX research & Strategy

The DXY index has slipped by >10% from its peak in Sep 2022 and this was on the back of multiple pivots by the Fed (since then), greater-than-expected resilience in global growth and China's emergence from zero-Covid. We have been in this inflection point of growth, inflation, monetary policy for a while now and we see a risk that the turning point for policy may potentially take longer to pan out for the US. There could be concomitant upside risks to the USD in the near-term, especially against Asian currencies.

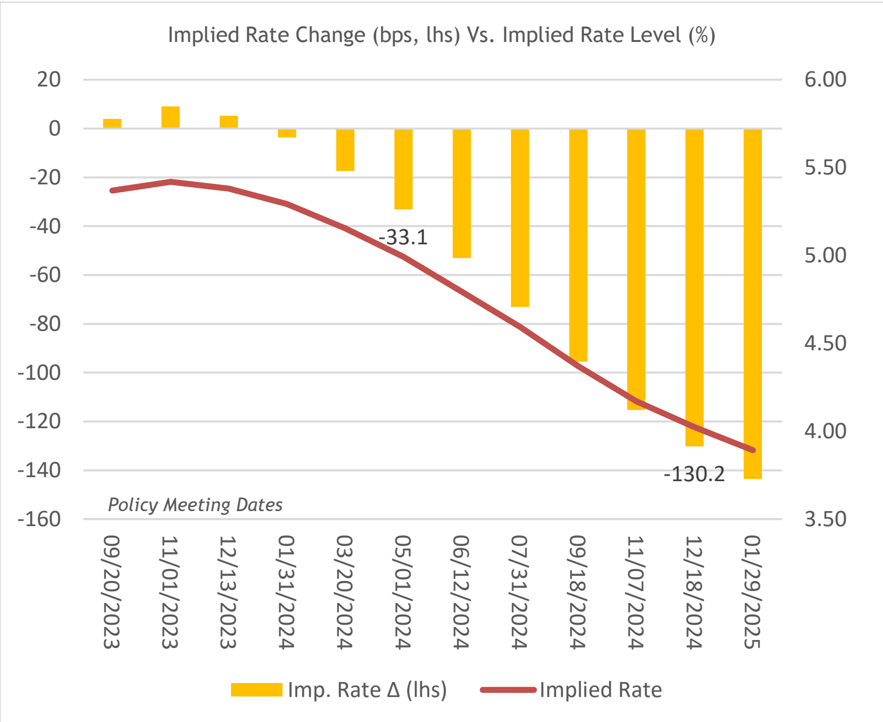
(1) "Fed is Done" is Largely in the Price

With Fed Fund futures implying around 30% probability of one more hike, markets have largely priced in the scenario that the Fed has reached the peak of its tightening cycle. Our base case is that the Fed is done with the tightening cycle already. However, any upside surprise in inflation prints or pick-up in wage growth could spur hawkish re-pricing of the Fed, leading the UST2y yield as well as the USD a tad higher. Recall that the recent average hourly earnings for Jul (released alongside Jul NFP) had surprised to the upside at 4.4%y/y, albeit still steady from the month prior. **On the flipside, since the "Fed-is-Done" is already base case for majority of market participants, that limits room for USD downside even if the Fed provides a clearer signal of an extended pause at the subsequent meetings.**

(2) High for Longer Risks Emerge *if* the US economy Stays Resilient

At the Jul FOMC press conference, Fed Powell revealed that the Fed staff no longer projects a recession for the US. Some Fed officials are also flagging the possibility that the US can achieve a soft-landing scenario – a situation where the Fed conquers inflation without much job losses or even a growth contraction. This could mean that the Fed would probably be able to keep the Fed Fund Target Rate at current elevated levels for a longer period than expected. At this point (10 Aug 2023), Fed Fund Futures already imply a 130bps cut by end 2024. A full cut could happen as soon as May 2024 (see chart below).

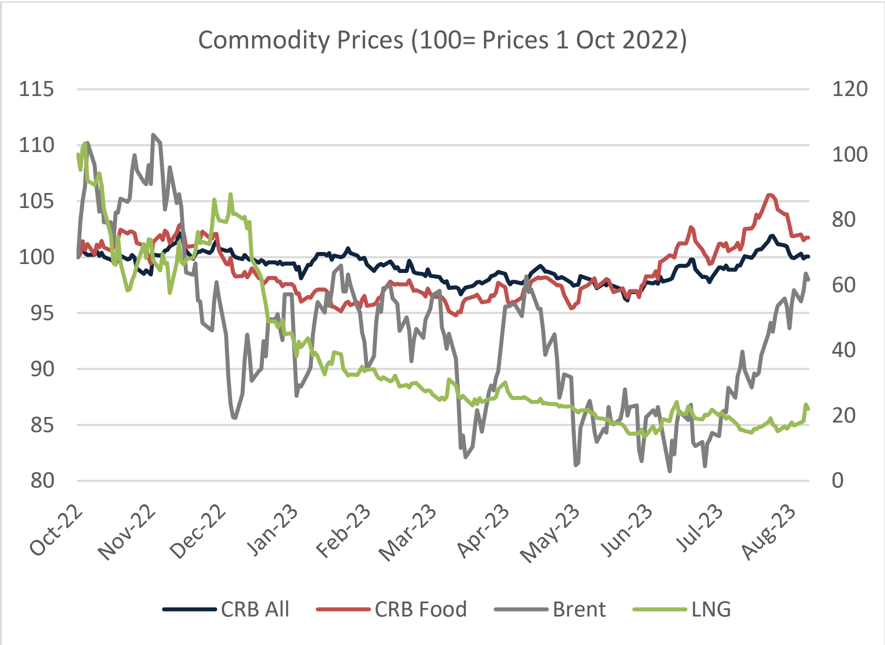
Chart 2: Fed Fund Futures Imply a 130bps Cut by Dec 2024 (as of 10 Aug 2023)



Source: Bloomberg, Maybank GM FX Research & Strategy

Current market pricing leaves ample room for market positioning to swing towards less aggressive bets on Fed's rate cut trajectory should US economy prove more resilient than expected. This is especially so with the confluence of recent events (drone attack on Russian oil tanker, industrial action in Australia's LNG plants, El Nino), that seem to have lifted commodity prices (oil, LNG, food) from year lows. While a significant rally like what we have seen in 2022 is unlikely as weakening global demand continues to provide offset for supply-induced price gains, a gradual recovery in commodity prices could be worrying enough to raise inflation expectations and for policy makers to keep rates on hold for longer. Such a scenario may lift USDAsian in three ways.

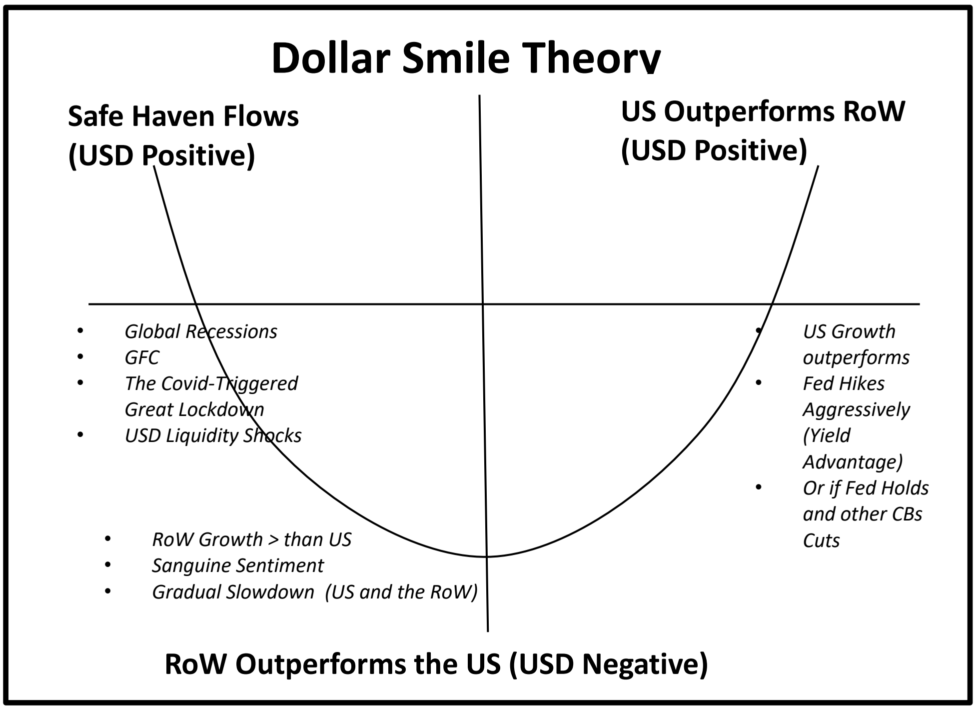
Chart 3: Commodity Prices Seem to be Bottoming



Source: Bloomberg, Maybank FX Research & Strategy

(1) US economic resilience vs. the rest of the world and concomitant policy divergence could potentially buoy the USD broadly against most currencies (EM or DM). This is supported by the USD smile theory - the USD's higher carry vs. most other currencies could support the USD.

Chart 4: Dollar Smile Theory



Source: Maybank GM FX Research & Strategy, originally observed by Stephen Li Jen

(2) US data that suggests further US economic resilience could spur the UST curve to bear steepen. We looked into the past behaviours of the UST curve and its impact on currencies. Typically, bear steepening of the UST curve happens when the inflation expectations in the US rise, leading to a rise in 10y yield that surpass the rise of the 2y. Such episodes (shown in Table 1) typically see Asian currencies underperform with traditionally higher yielding currencies under more pressure vs. the rest. This is due to the fact that the rise of the UST 10y yield should reduce the carry advantage of higher yielding EM FX and spur an unwinding of carry trades in general.

Table 1: Historical FX Behavior to Shifts in Different Yield Curve Regimes

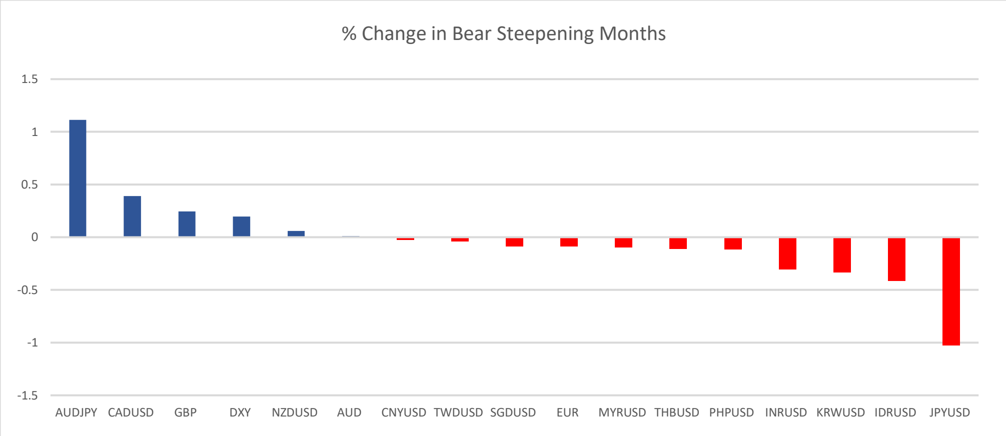
	Bull Steepen	Bull Flatten	Bear Steepen	Bear Flatten
DXY	-0.99	0.08	0.20	0.25
AUDJPY	-1.21	-0.55	1.11	1.01
JPYUSD	1.59	0.72	-1.03	-1.00
EUR	1.20	-0.06	-0.09	-0.12
GBP	0.68	-0.51	0.24	-0.15
AUD	0.33	0.11	0.01	-0.02
NZDUSD	0.21	0.39	0.06	-0.21
CADUSD	-0.11	-0.13	0.39	0.03
KRWUSD	0.71	0.07	-0.33	-0.03
TWDUSD	0.62	0.00	-0.04	-0.26
SGDUSD	0.52	0.18	-0.09	-0.06
MYRUSD	0.20	-0.01	-0.10	-0.16
IDRUSD	0.29	0.00	-0.41	-0.56
THBUSD	0.54	0.04	-0.11	0.11
PHPUSD	0.11	-0.05	-0.11	-0.21
CNYUSD	0.27	0.14	-0.03	-0.09
INRUSD	-0.02	-0.09	-0.31	-0.34

Note: All yield curve regimes are defined by changes in the 2y10y spread and the above data (2000-2023) are **average monthly changes** for each currency pair. For example, the DXY index declines by an average of -0.99% in months when the US Sovereign curve bull steepened. Bull steepening is defined by a fall in interest rates and a rise in the 2y10y yield spread.

Source: Bloomberg, Maybank GM FX Research & Strategy

For much of the past 7 months of 2023, UST 10y yield remained within the 3.3-4.3% range (a 100bps range), relatively steady compared to the 300bps rise seen in 2022. While UST yields were elevated, lower volatility has enabled carry trades to thrive. Our house view looks for a 200bps cut in 2024 which should spur a bull steepening and that provides a relatively more benign environment for Asian currencies. In the near-term however, we see room for bear-steepening scenarios (US data indicating resilience) and Asian currencies could come under pressure as a result.

Chart 5: Most Asian Currencies Come Under Pressure in Bear Steepening Months



Source: Bloomberg, Maybank GM FX Research & Strategy

(3) Rate Cuts Risk Rising in the Region, Undermining Asian Currencies

With China's growth still under pressure (our China economist just downgraded GDP forecast from 5.0% to 4.6% for 2023) and Asian exports still under pressure, regional economies are increasingly reliant on domestic demand. Inflation has also eased significantly in the region (Malaysia, Indonesia, Thailand, Philippines, Vietnam) relative to the western peers. Central banks in the region have mostly remained hawkish. BoT have assured that rate cuts are not on the table yet. BSP looks for inflation below 2-4% target early 2024. For BI however, there are already some expectations for the central bank to cut within the year. Should growth metrics (credit growth, business sentiment, consumer confidence) for any regional nation show more discernible weakness, the turn in the policy cycle within the region may be sooner than the Fed and that could in turn, weigh on the respective regional currencies.

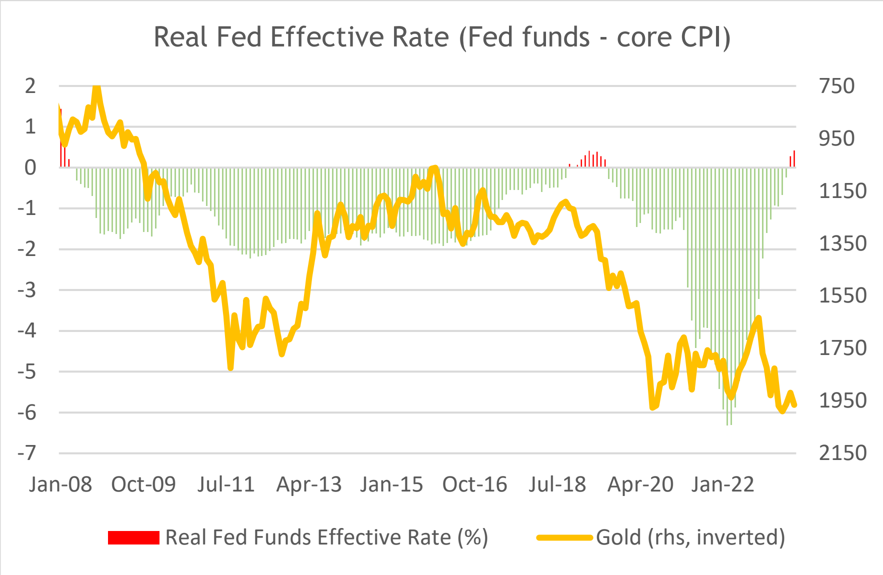
Taken together, market positioning and macro environment have tilted risks to the upside for USDAsians. Early indicators of China economy also suggest that economic momentum there continues to languish in Jul and Asian FX is not likely to be able to get support from China. Fortunately, PBoC continues to limit yuan weakness via the daily USDCNY reference rates, effectively capping USDCNY around 7.30.

With risks tilted to the upside for energy prices, we see potential for commodity-linked CAD, MYR and AUD to strengthen against IDR, INR and JPY. The latter are highest-yielding currencies which are typically more vulnerable when UST 10y yield tend to rise. Low yielding JPY will also remain under more pressure. In addition, our economist sees some risk of a rate cut in 4Q for Bank Indonesia.

Other Collateral Damage for High for Longer Risks - Gold

In an environment of an extended pause for Fed policy rate, we see a risk for real rates to rise as inflation continues to ease. Policy becomes restrictive even as Fed does not continue to hike. An environment of rising real rates could be negative for **gold**. Key support to watch is still the \$1892/oz. A break there to open the way towards the next support at \$1840/oz. Rebounds to meet resistance around \$1984.

Chart 6: Real Fed Effective Rate Has Turned Positive, Limiting Gold's Advance



Source: Bloomberg, Maybank GM FX Research & Strategy

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