FX Insight

Asia FX - How Insulated to Fed Tightening

USD Supported in the Interim But to Fade Into 4Q

In this report, we look at the impact on various asset classes including FX and what markets are now expecting in terms of Fed normalisation time line. We also look at how vulnerable or insulated regional FX are to Fed shifts via 2 analytical approaches: (1) extent of impact from Fed tightening via beta sensitivities to changes in nominal, real UST yields and (2) refreshing our ASEAN FX vol model to gauge if depreciation risks are under-priced.

Based on our study on AXJs' sensitivity to Fed's shifts, IDR, JPY and KRW are expected to be the most vulnerable given potential for carry trades to unwind (for high-yielding IDR) or to flourish (for funding currency JPY). KRW's risk-sensitive nature renders it susceptible to Fed's shifts as well. In contrast, the AAA sovereign credit ratings of SGD, AUD and NZD make them comparatively more attractive in a rising rate environment. For CNY, PBoC tends to dampen excessive volatility in the RMB including any Fed-induced taper tantrums or tightening fears, potentially resulting in its outperformance against more volatile regional peers.

Meanwhile, a refresh of our ASEAN FX volatility model suggests that while there may be modest under-pricing of depreciation risks as of end-Jun, the extent of "under-pricing" is likely not excessive. Barring materialization of new negative risk drivers, any bouts of softness in AXJ FX looks less likely to manifest into a severe sell-off tantrum. In particular, CNY volatility (significant at the 1% level in explaining ASEAN FX vols) has declined since Biden won the US elections, and a more stable CNY could be helping to buffer shocks to ASEAN FX.

On FX tactical cross plays in the interim, we favour long RMB and SGD vs. short IDR and THB (worsening Covid situation - vaccination laggard and Covid resurgence, lockdown risks).

Looking out when Fed's guidance offers greater clarity of policy normalisation, we would be inclined then to sell JPY vs. long KRW (on the back of hawkish BoK, constructive macro fundamentals and semiconductor story.

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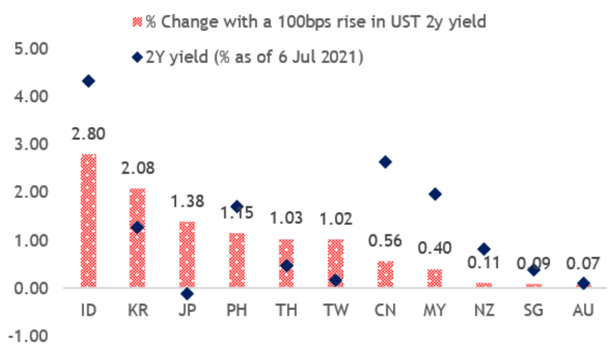
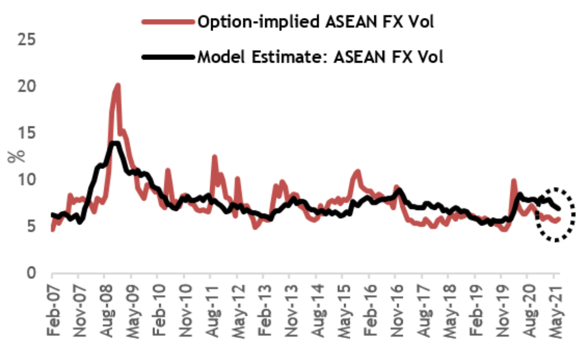
IDR, KRW & JPY Most Sensitive to Fed's Hawkish Shifts



Note: X-axis denotes the respective sovereigns and the red bars shows the sensitivity of the respective currencies to 100bps change in 2Y UST yields. For example, USDIDR rises 2.8% with 100bps rise in UST 2Y yield. Blue diamonds show the level of 2Y yield of the respective sovereign bonds.
Source: Maybank FX Research & Strategy Estimates

Modest Under-pricing of Risks in ASEAN FX



Note: For model parameters, refer to main report.
Source: Maybank FX Research & Strategy Estimates

Fed's Policy Normalisation – Can Asia FX Handle?

(1) Yield Curve Flattening, USD Shifts

Market dynamics have started to shift since Fed's surprise hawkish tilt at the last FoMC (16-17 Jun), which included Fed officials looking for 2 hikes in 2023 (see our earlier note here for our quick thoughts on FoMC) while a few Fed officials also started to sound more hawkish alongside strong US data.

In this report, we look at the impact on various asset classes including FX, what markets are now expecting in terms of Fed normalisation timeline and also the line-up of FoMC officials (to get a sense of hawk-dove bias).

In terms of quantitative analysis, we first look at how vulnerable or insulated regional FX are to Fed shifts via beta sensitivities to changes in nominal and real UST yields. While discussions around these sensitivities largely revolve around Fed policy normalization as the key risk driver, we note that the current risk landscape is also interspersed with jitters arising from ongoing Covid challenges as well as ad-hoc events such as US debt ceiling concerns (more details on these in Boxes near the end of the report).

We hence take the opportunity to refresh our ASEAN FX volatility model (first introduced in Oct 2020), as a check on whether markets are over-pricing or under-pricing broader risk conditions.

We then conclude with our findings and our preferred FX tactical plays.

Post-FoMC Market Reaction Thus Far Suggest a Change in Market Dynamics

The popular bear steepener trade which started in Sep-2020 feels very passé as UST yield curve bear flattened. 2Y10Y UST flattened by ~18bps, from 136bps (pre-FoMC) to 118bps (as of 6 Jul) but on YTD from peak change, 2Y10Y UST yield curve has already flattened by ~40bps. In particular front end rates moved more, as markets priced in Fed hikes.

Historically we also observed that Fed tightening of policy rates coincided with periods of flattening/inversion of yield curves. So to some extent, we expect the pace of bear flattening of yield curve to slow unless Fed unexpectedly brings forward policy normalisation timeline.

For now, we still expect Fed to focus on taper timeline but short of an imminent taper as Fed Chair Powell emphasized that the Fed would provide ample notice ahead of taper. We still think it is possible Fed comes forth with a taper timeline for the future sometime at the Jackson Hole Symposium (26 – 28 Aug) or Sep FoMC. Market chatters suggest a monthly reduction of $10bn (from its $120bn QE purchase/ month), starting in Jan-2022 and ending QE by end-2022.

Chart 1: Front-End Rates Rose More Post-FoMC as Markets Price in Rate Hikes

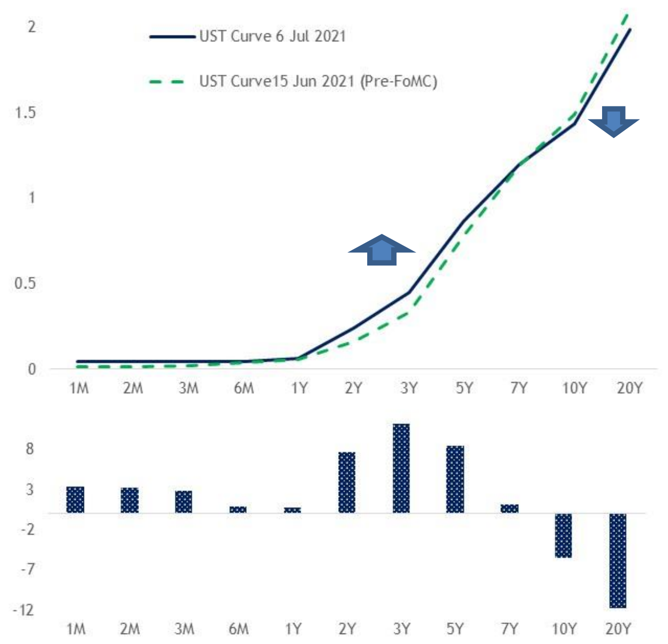
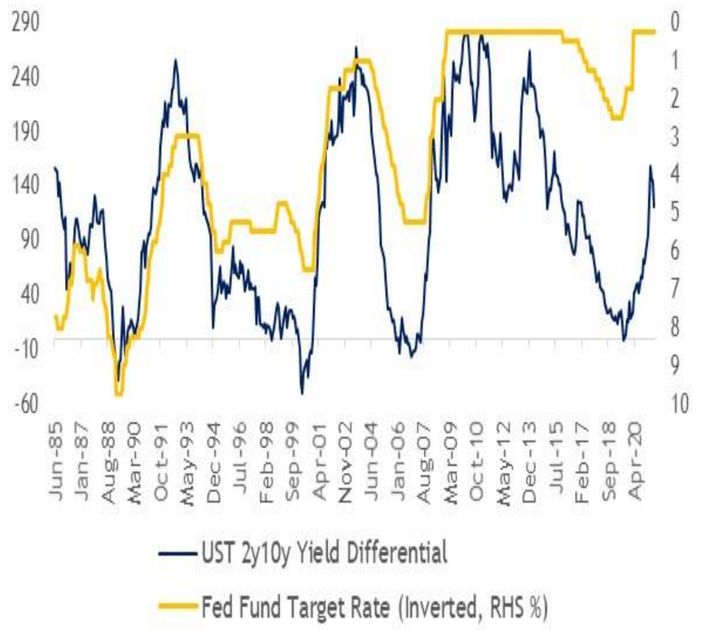


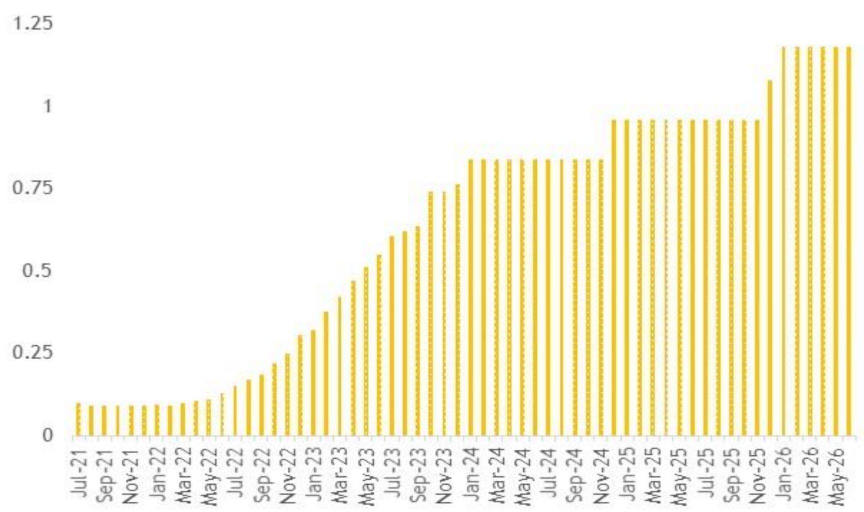
Chart 2: UST Yield Curve Bear Flattened but Pace Should Slow From Here Unless Fed Unexpectedly Tightens Policy



Source: Bloomberg, Maybank FX Research & Strategy

Looking at 30 day Fed Fund futures, the implied policy expectations suggests about 1 hike priced for 2022, 2 hikes for 2023 and another hike priced each for 2024 and 2025, cumulatively about 125 bps priced. We opined that rates markets have reasonably priced in a fair degree of Fed tightening, alongside a firmer USD since the recent FoMC. The risk is an earlier start to tapering and this could add to USD firmness.

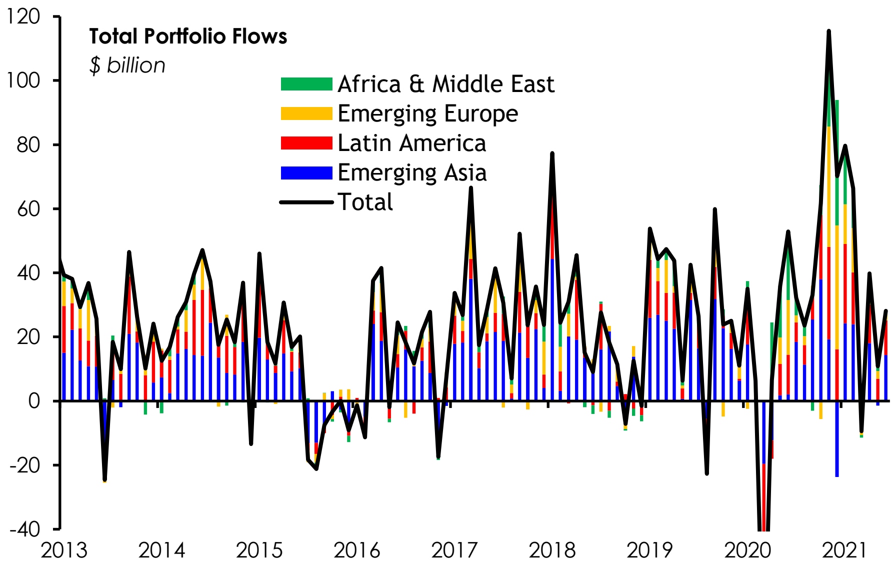
Chart 3: Markets Pricing In First Hike As Soon As End-2022



Source: Bloomberg, Maybank FX Research & Strategy

The sell-off in risk assets post-Jun FoMC has stabilised. Commodities including copper, oil prices have rebounded while S&P500 and NASDAQ returned to print historical highs. From a flow perspective in Jun, IIF capital flows tracker estimated that foreign flows to EM stood at $28.1bn, with flows to EM Asia taking a 50% share. Total portfolio inflows mainly went into debt, accounting for $18.9bn of which $10.4bn were EM Asia. Fed's hawkish shift may have affected foreign portfolio flows in Jun 2021 but looking at past periods, including taper tantrum in 2013, the overall picture from a flow perspective remains positive.

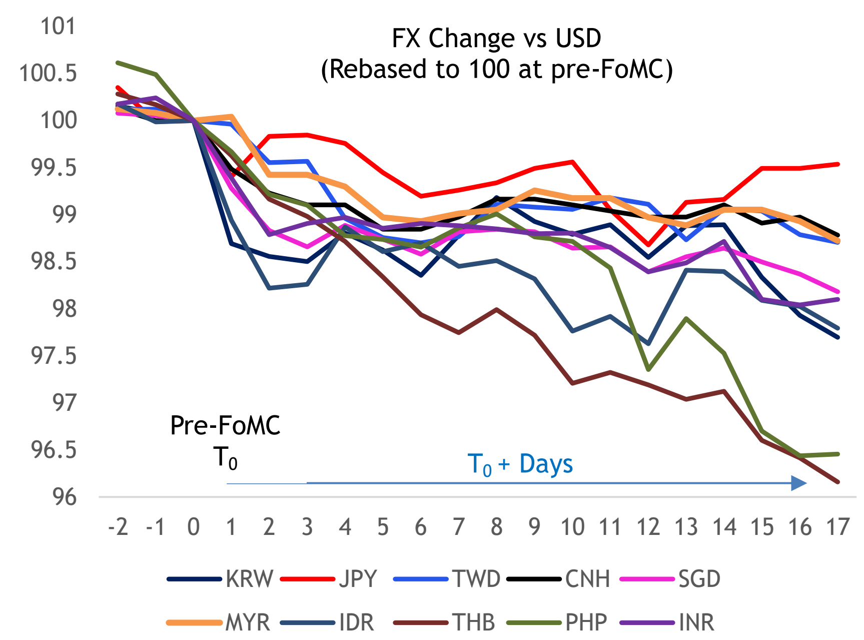
Chart 4: Foreign Portfolio Inflows into EM Asia Continues in Jun but in Moderation



Source: IIF estimates, National Sources, Bloomberg, Maybank FX Research & Strategy

In the FX space, most AXJ FX depreciated between 1% and 2% vs. USD post FoMC. However THB, PHP, IDR and KRW depreciated more, by 2% - 4%, compounded by worsening Covid situation at home. We take a closer look on currency sensitivity to changes in Fed shifts in the next section.

Chart 5: THB, PHP, IDR and KRW Main Underperformers



Source: Bloomberg, Maybank FX Research & Strategy

For Thailand, **the spread of delta variant and relatively low rate of vaccination suggests that infections and death toll could rise further**. As of 8 Jul, Thailand reported more than 7,000 new cases (a 30 fold surge from 250 cases/day since early Apr 2021) and 75 new deaths (new daily record). This could jeopardise PM Prayuth's mid-Oct deadline to fully reopen Thailand to vaccinated tourists (tourism contributes ~20% to pre-pandemic GDP). BoT also warns that a prolonged outbreak could cause the economy to underperform baseline expectations (2021 growth forecast was cut to 1.8% from 3.0% prior in the last BoT meeting).

For Philippines, Covid spread has somewhat showed signs of stabilisation after the surge in Jun. Daily infection (as of 7 Jul) has fallen below its 7D moving average of 5,000 cases/day **however Philippines has been a vaccine laggard** with less than 10% of population (as of 6 Jul) in Philippines receiving one dose, the lowest amongst ASEAN peers. There were also reports of several cities in the capital region pausing their first-dose vaccination program amid supply constraints. The situation going forward may improve as Philippines is expected to received 16mio vaccines this month and another 14mio vaccines next month. A ramp up in inoculation in coming weeks could see Philippines play catch up.

Indonesia entered into a lockdown (3 – 20 Jul) amid resurgence in Covid spread. Daily new infection rose above 34,000 (7 Jul) while the 7-day average in new cases has more than quadrupled to >27k (as of 6 Jul), vs. 6k one month ago. Authorities are preparing backup medical facilities for a worst-case scenario where daily infections reach 40k-50k. The government has also acknowledged that GDP growth will likely fall below the target of 4.5% to 5.3% announced earlier, given recent Covid curbs. Covid-related curbs were expanded (7 Jul), across dozens of new cities from Sumatra in the west to easternmost Papua. The wider restrictions would force the majority of non-essential employees to work from home, as well as limit shops and restaurant hours (75% of people are expected to work from home). The stricter curbs were initially announced for Jakarta, Java and Bali last week, but strains on overwhelmed healthcare facilities have forced action to be taken in lesser-hit regions as well.

South Korea unexpectedly saw a resurgence in Covid infection as it recorded rising cases in the past week with a highest one day jump of 1,275 cases (as of 7 Jul). The government is now considering to impose its highest level of movement restrictions as the current 4th wave (largely due to delta variant) is spreading rapidly. South Korea has a relatively higher vaccination rate of 30% (for those receiving at least 1 dose) vs. other ASEAN ex-Singapore peers but vaccination pace has since slowed.

Chart 6: Resurgence in Covid Infection with Indonesia in the Lead (Daily New Cases – Log)

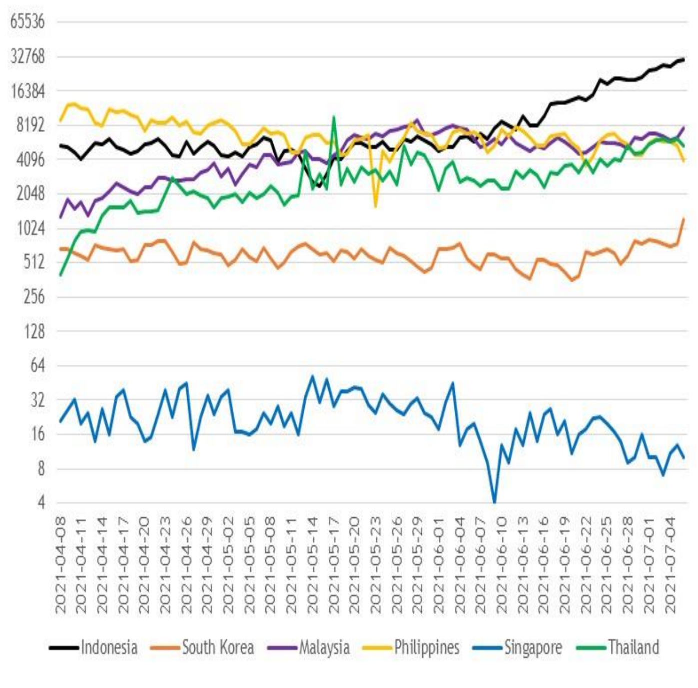
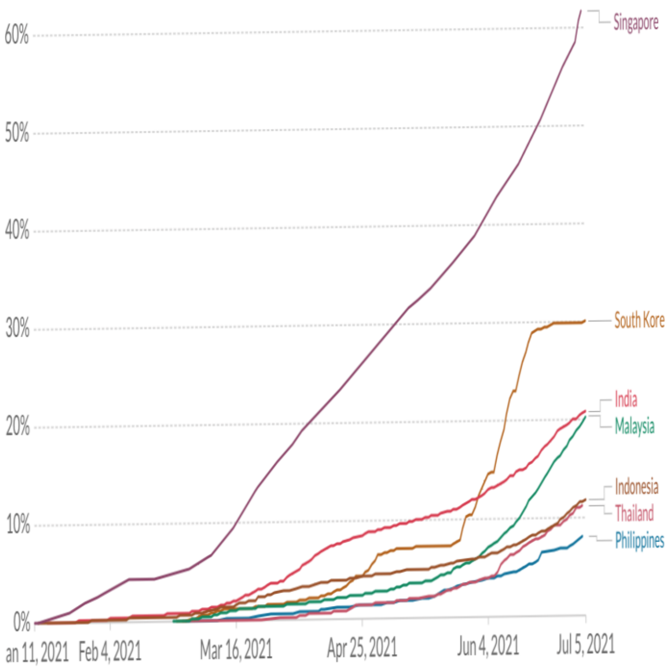


Chart 7: Philippines and Thailand Lagged Peers in Vaccination (Share of People who Received at Least One Dose of Vaccine)



Source: ourworldindata, Maybank FX Research & Strategy

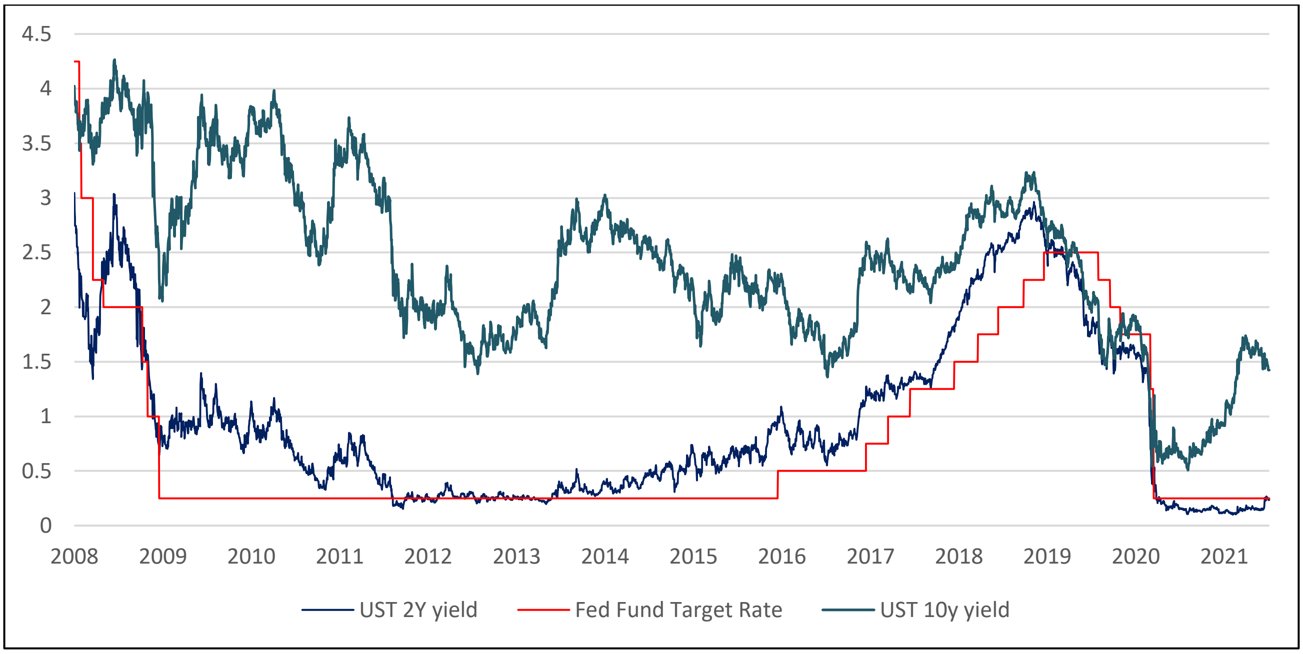
On net, with markets pricing in Fed shifts towards policy normalisation, AXJs whose central banks are reluctant or not able to tighten could face FX depreciation pressures. In particular, AXJs that still face Covid resurgence (delta, kappa, lambda variants), vaccine supply issues and/or are slow at vaccinating their people could risk prolonging or tightening restrictions and this could result in delays in reopening their economies. There could be further negative repercussions for AXJs if more DM central banks move to tighten policies (as their epidemic curves flatten amid rapid inoculation pace) and reopen their economies while AXJs are still battling with Covid spread.

2a) Analytical Approach: Asia FX Sensitivities to Yield Changes

Understanding the Resilience of Asia FX should Fed Normalize

Given the impending change in global monetary conditions post Fed's hawkish shift, we sought to investigate the resilience of regional currencies. We derived the sensitivity of Asia FX to movements in the 2Y UST yields by the method of ordinary least squares for linear estimation. We chose the 2Y UST yield as it is the most reactive to policy changes by the Fed. In fact, the 2Y UST yield jumped >12bps in the lead-up to the Jun 2021 FOMC meeting and beyond. It then touched a high of 0.2681%, a 14-month high before tapering off. This is rather consistent in past monetary policy cycles of the Fed. Meanwhile, a drop in the 10Y yields was observed in the past few weeks.

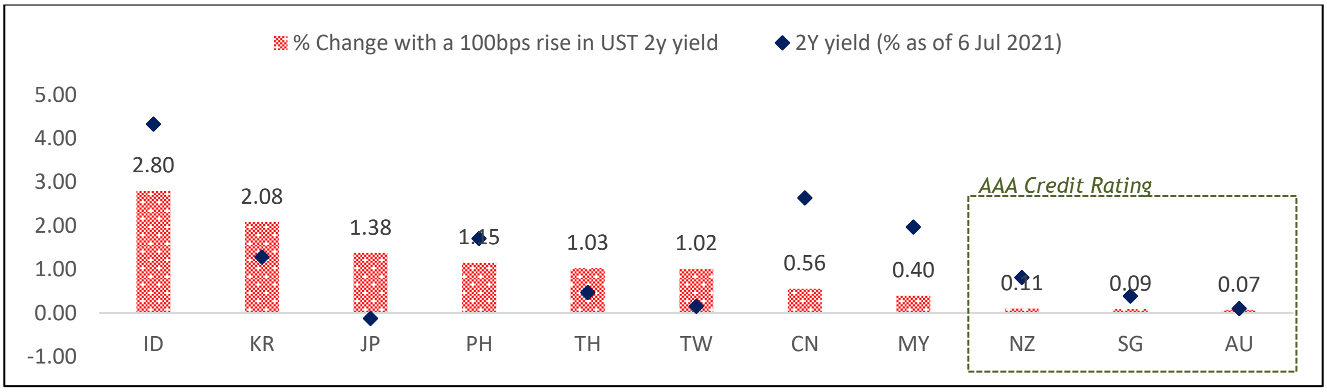
Chart 8: UST 2Y Is More Reactive to the Fed Fund Target Rate Vs. Conventional 10Y



Source: Bloomberg, Maybank FX Research & Strategy

Our sample consists of Asian currencies (in the form of USDFX) and UST yields over the period of Jan 2009- Jul 2021. On the whole, findings suggest that a rise in 2Y yield should see weakness across most regional currencies against the USD but to varying extent with IDR, KRW, JPY most vulnerable to US yield movements. For example, IDR weakens 2.8% against the USD with a 100bps rise in 2Y UST yield.

Chart 9: How Sensitive Are Regional Currencies to Fed's Policy Changes



Note: X-axis denotes the respective sovereigns and the red bars shows the sensitivity of the respective currencies to 100bps change in 2Y UST yields. For example, USDIDR rises 2.8% with 100bps rise in UST 2Y yield. Blue diamonds show the level of 2Y yield of the respective sovereign bonds

Source: Maybank FX Research & Strategy Estimates

IDR Most Sensitive of the Lot. We pin the IDR's high sensitivity to its high level of bond yields, giving IDR the allure of carry advantage in an environment of low inflation, low growth and low rate. However, once Fed starts to signal a shift in policy bias and treasury yields jump in response, carry trades that favoured IDR typically unwind and IDR is disproportionately affected. Yield level can also explain JPY's sensitivity to Fed's policy shifts. The JPY has been negative-yielding for a good portion of the past decade and a known funding currency for carry trades. A rise in US rate could widen the UST-JGB yield differential and effectively weaken the demand for JPY. Korea's bond yield may not beat CNY, MYR and PHP but its nature as risk-sensitive currency renders the currency susceptible to UST volatilities as well.

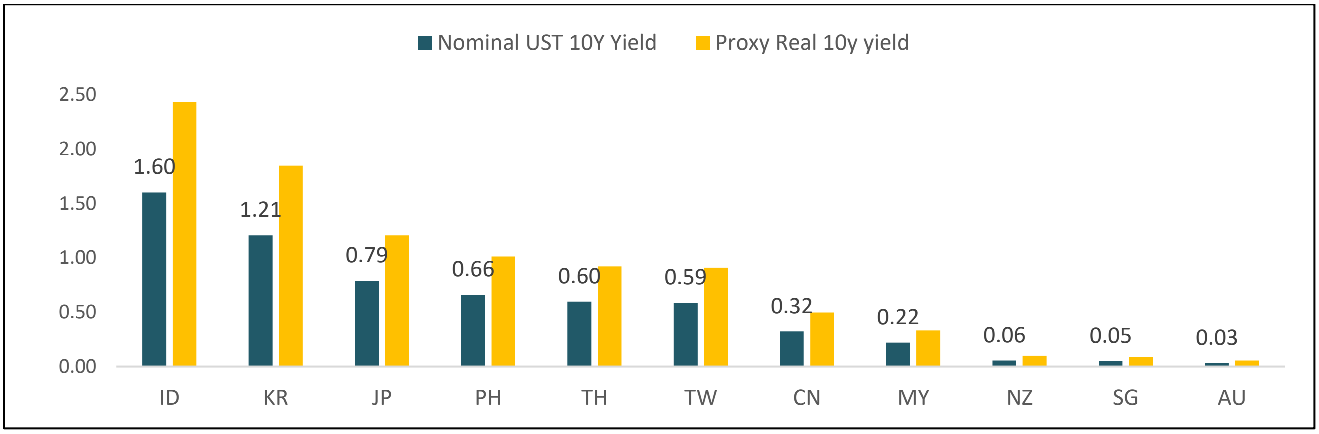
AUD, SGD, NZD the Least Sensitive. In contrast, AUD, SGD, NZD's sensitivity to 2Y yields were relatively limited - only depreciating 0.07-0.11% vs. the USD upon a 100bps rise in 2Y yield. This could be due to the fact that they have a high credit rating. All three countries have AAA rating so investors typically do not flee from these sovereigns in times of stress. We also note that their yield levels are also at the lower end of the positive spectrum and are thus less affected by shifts in carry trade impetus. In the current context, these sovereigns continue to remain strong in terms of fiscal position relative to regional peers. It is thus of no coincidence that they are also the countries in the region that have been able to overcome COVID-19 with the best economic outcomes thus far. Should Fed start to tighten, AUD, SGD and NZD could remain the most resilient of the lot.

RMB Can Offer Stability in Times of Fed-Induced Volatility. China's 2Y bond yield may be comparatively higher but the proportion of foreign owners of CNY-denominated assets are relatively low in the past decade. CNY has thus been less reactive to UST movements between 2009-2021. PBoC has been voicing concerns about potential volatility that can emanate from Fed's policy shifts since May this year and urged corporates to avoid betting on CNY gains and to be ready for 2-way movements in the RMB. Part of PBoC's exchange rate policy is its ability to influence the FX market via the daily USDCNY reference rate fixes. In times of UST volatility, we may see PBoC impart some stability via the daily USDCNY reference rates and that could also serve to anchor the regional currencies.

Asia FX More Sensitive to Real Than Nominal Yields

During the past rate hiking cycles, UST 10Y does rise at some point, albeit at a slower pace than the 2Y (shown in chart below). We also regressed respective currency pairs on UST 10Y yield as well as Fed's proxy for real 10Y yield. Beta-wise, the sensitivity of USDAsia FX to UST 10Y was lower compared to 2Y. For example, USDIDR rise only 1.6% when UST 10Y yield rise by 100bps compared to 2.8% for a 100bps increase in 2Y. However, we also found all currency pairs to have stronger sensitivity to real yield changes compared to nominal yields as seen in the chart below.

Chart 10: Regional Currencies React More to Real Yield Vs. Nominal yield.



Note: X-axis denotes the respective sovereigns and the green and yellow bars shows the sensitivity of the currencies to 100bps change in 2Y UST yields and 10Y UST yields respectively. For example, USDIDR rises 1.6% with 100bps rise in UST 10Y nominal yield.
Source: Maybank FX Research & Strategy Estimates

(2b) Analytical Approach: ASEAN FX Vol Modelling

The above derivation and discussion on sensitivities largely revolve around Fed policy normalization as the key risk driver, but as highlighted at the start of the report, the current risk environment is a complex one. Not only did Fed's mid-Jun hawkish tilt catch markets off guard, differential Covid challenges in different jurisdictions, as well as ad-hoc events such as US debt ceiling deadlines, add to the plethora of market concerns.

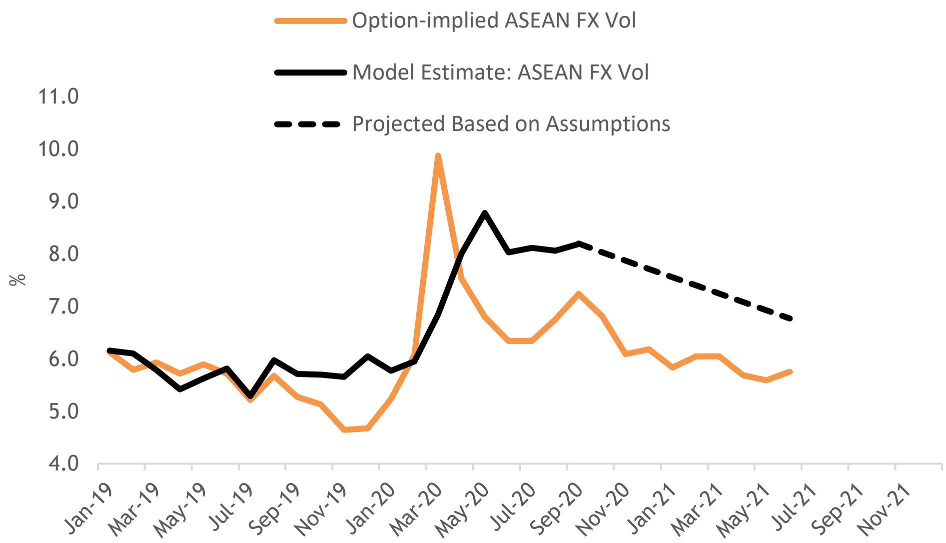
We hence take the opportunity to refresh our ASEAN FX volatility model, as a check on whether markets are over-pricing or under-pricing broader risk conditions.

But first, a quick recap. On 16 Oct last year, just a few weeks before the US elections, our insight piece (*Final Lap to Elections and Beyond*) highlighted two key findings with regards to the regional FX volatility landscape.

(i) We cautioned that markets were underestimating volatility risks heading into the US elections (actual ASEAN FX option-implied vols were relatively low then versus our model estimates; see chart below) and that there was potential for more turbulent developments to set in then.

(ii) That after the near-term turbulence post-elections, there was a "window" of benign macro conditions in 2021, alongside gradual demand recovery, and lower-for-longer rates, anchored on continued positive vaccine developments, resulting in a downtrend in ASEAN FX vols which would be beneficial for ASEAN FX.

Chart 11: ASEAN FX Vol Projection Chart (16 Oct 2020), Now Updated with Actual Vols Outturns



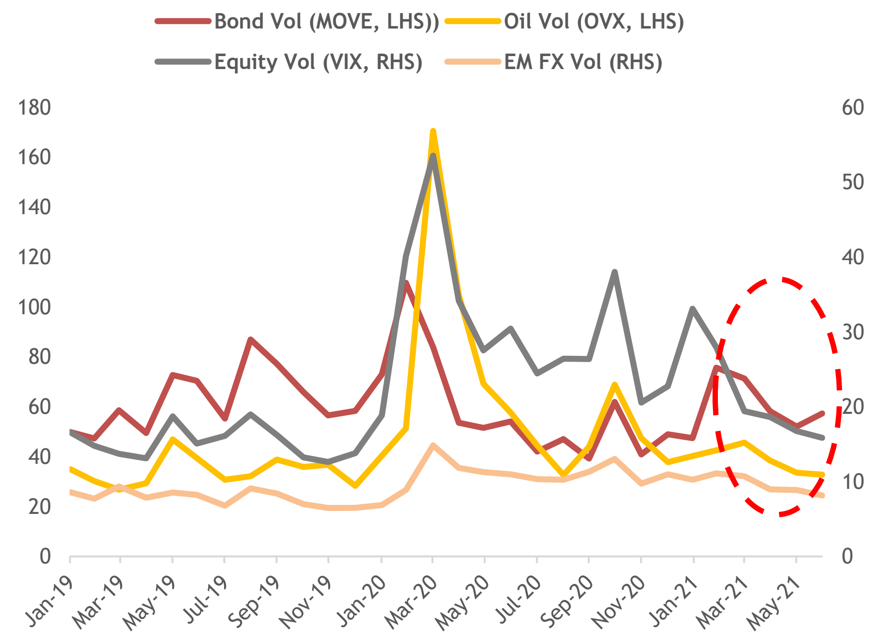
Note: ASEAN FX Vol refers to average of 3M implied volatilities for USD-ASEAN FX pairs (i.e., USDSGD, USDMYR, USDIDR, USDTHB, USDPHP), in monthly data form. For model assumptions made in Oct 2020, pls refer to earlier report *Final Lap to Elections and Beyond*.
Source: Bloomberg, Maybank FX Research & Strategy Estimates

Both of these findings largely came to pass.

While not obvious from the orange line on the chart on monthly close basis, some turbulence did set in on US elections day as preliminary results see-sawed between Biden and Trump. USDCNH had spiked by almost 2% at one point, while some USD-ASEAN pairs had surged by >1% as well.

After Biden won though, as we suggested, ASEAN FX vols have been largely on a downtrend in 1H 2021. Aside from FX, we note that after the bout of US yield recalibration in 1Q (which spilled over to equities as well), vols across various asset classes have been largely constrained in 2Q.

Chart 12: Vols Across Asset Classes Largely Constrained in 2Q 2021



Source: Bloomberg, Maybank FX Research & Strategy Estimates

With market sentiments still largely benign, it may well be time to ask ourselves whether some caution is warranted ahead.

FX Vol Model Implies Some Under-pricing of Downside Risks for ASEAN FX

For our ASEAN FX vol model, the key variable we look at is the average of 3M implied volatilities for USD-ASEAN FX pairs (i.e., USDSGD, USDMYR, USDIDR, USDTHB, USDPHP), in monthly data form. This series is available from 2006.

To recap, the model takes into account the following factors in explaining ASEAN FX vols:

- **3M10Y US Term Premiums**: To a certain extent, this reflects differentials in near-term and long-term risk/growth expectations, and may be a proxy for broad reflation sentiments. Enters model in level terms.
- **Interest Rate Volatility**: We take the volatility of the differentials between US Fed rates and average of ASEAN policy rates. This variable is meant to capture uncertainty surrounding shifts in differential monetary policy conditions between US and ASEAN. 3MSIBOR is used as a proxy for Singapore's "policy rate" given its usage of an exchange rate monetary policy tool.
- **USDCNY 3M Implied Vol**: China's tight trade and investment linkages with ASEAN often means that their currencies display significant co-movement. Spikes in USDCNY volatility over the past few years during bouts of trade tensions have presumably spilled over to USD-ASEAN FX pairs as well.
- **US Macro Policy Volatility**: The Baker, Bloom and Davis daily news-based Economic Policy Uncertainty Index is based on analysis of newspaper content and captures volatility in expectations surrounding the trajectory in US economic policies. *Index of 100 = Long-term Average*. Potential changes in policy regimes as a result of events (e.g., Covid) or US elections can have deep implications for ASEAN assets.

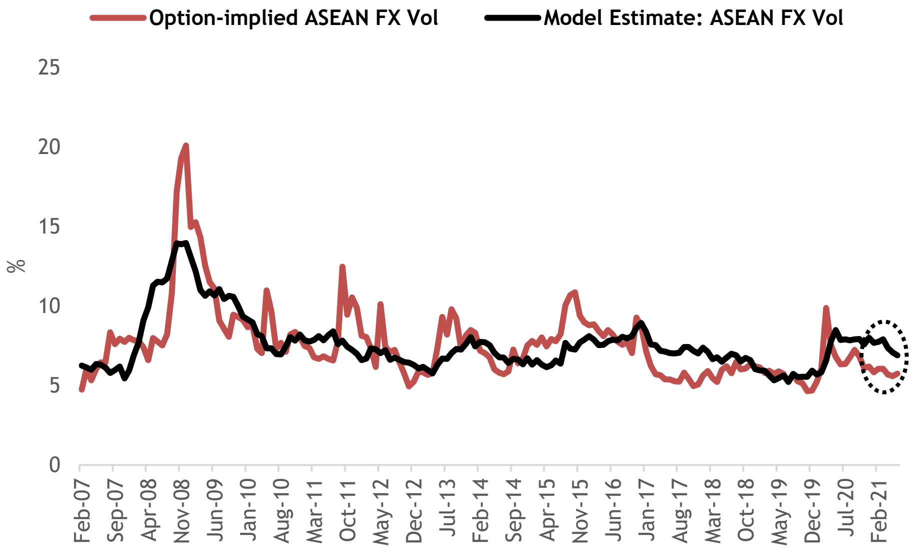
Results shown below but note that coefficients are not comparable as variables have different units.

Table 1: Model Coefficients

	ASEAN Implied FX Vols
Constant	3.64**
3M10Y	0.87**
Policy Rate Volatility	5.02**
USDCNY 3M Vol.	0.30**
US Policy Uncertainty	0.0021*
Observations	*173*
Adjusted R-Squared	*0.50*

Note: Implied Vols refer to average of ATM 3M Vols of USD-ASEAN pairs. ** denotes significance at the 1% level, * denotes significance at the 10% level.
Source: Maybank FX Research & Strategy

Chart 13: Some Under-pricing of Risks in ASEAN FX, But Modest in Extent

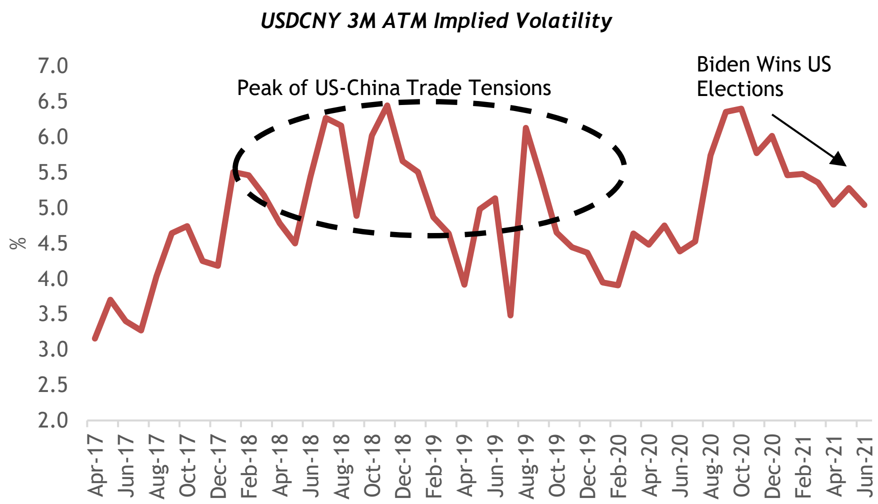


Source: Bloomberg, Maybank FX Research & Strategy Estimates

The chart suggests that while there may be some modest under-pricing of risks currently (i.e., ASEAN FX vols should be higher than actual at end-Jun given various conditions captured by explanatory variables), **the extent of "under-pricing" is likely not excessive at this point**. This could imply that while bouts of intermittent softness in ASEAN FX may be expected given the current risk landscape, this is less likely to manifest into a severe sell-off tantrum.

In particular, we note that CNY volatility (significant at the 1% level for ASEAN FX vols) has declined since Biden won the US elections, and a more stable CNY could be helping to buffer shocks to ASEAN FX.

Chart 14: A More Stable CNY Could Be Helping to Buffer Shocks to ASEAN FX



Box 1: US Debt Ceiling—Not a Huge Cause for Concern But Monitor Jitters

The US Debt Ceiling Limit is a legislative limit on the amount of national debt that can be incurred by the US Treasury, thus limiting how much money the federal government may borrow. In effect, it can only restrain the Treasury from paying for expenditures and other financial obligations after the limit has been reached.

A vote to increase the debt ceiling has usually been (since the 1950s) a legal budgetary formality between the President and Congress. Rather than the usual debt ceiling increase, the ceiling was suspended in Feb 2013 for the first time, till May 2013. The debt ceiling stood at US$16.699trn then. Since then, a series of suspensions (Oct 2013->Feb 2014, Feb 2014->Mar 2015, Oct 2015->Mar 2017, Sep 2017->Dec 2017->Mar 2019, Aug 2019-> 31 Jul 2021) has occurred.

Currently, markets are looking to 31 Jul as a key deadline after which the previous suspension will lapse. If no increase/suspension is implemented before then, the government will need to take more drastic action to slow down spending. Non-essential government spending pauses, hitting a range of programs and agencies, and likely inducing growth and employment concerns. The Treasury will also need to resort to "extraordinary measures" to temporarily finance government expenditures and obligations until a resolution can be reached.

While the Treasury has never reached the point of exhausting extraordinary measures, resulting in default, jitters can still set in as uncertainty in markets emerges.

To better understand how markets react to such risk events, we use developments in 2011 and 2019 as points of reference.

Key Events in 2011

Date	Key Developments
Jan 28	Moody's said it **may place a "negative" outlook on the AAA rating of US debt** sooner than anticipated, as the country's budget deficit widened.
Apr 18	S&P's Ratings **revised its outlook on the US to negative** due to recent and expected further deterioration in the US fiscal profile.
May 16	The **debt ceiling is reached. Debt issuance suspended**, directing the Treasury to utilize "extraordinary measures" to fund federal obligations.
May - Jul	Deal-making in Congress.
Jul 31	Obama announced that leaders of both parties had **reached an agreement** to lift the debt ceiling and reduce the federal deficit.
Aug 2	Obama signed the debt ceiling bill, ending fears of a default.
Aug 5, 2011	S&P's **lowered the credit rating of the US from AAA to AA+,** rated the **long-term outlook as negative**, citing uncertainty in debt growth dynamics (i.e., deal as inadequate).

Source: Wikipedia, Bloomberg, Maybank FX Research & Strategy

As events played out, USD saw a V-shaped trajectory, declining up to 3.5% from Jan-Jul as debt deficit concerns were played up, but paring losses after deal was reached. The UST10Y yield trended down for most of 2011, alongside demand for safety in long-end treasuries (note: Europe debt crisis ongoing too). Equities were relatively unperturbed till Jul 2011, but ironically, the conclusion of the debt ceiling deal, which involving reduced government spending, as well as the subsequent S&P credit rating downgrade, tanked markets (S&P500 -10%) from Aug.

Fast Forward to 2019. The federal debt limit expired on 1 Mar 2019 and Congress took till 2 Aug 2019 to suspend the debt ceiling (with the Treasury taking temporary measures in between to fund expenses).

In 2019 though, markets were a lot calmer. USD saw 2-way swings. The UST10Y yield was led lower, but on separate driver of Fed rate cuts (described as insurance against speed bumps in economy). Equities saw brief spurts of volatility, but largely recorded robust gains amid actual solid consumer spending, robust labor market, housing recovery.

Currently, the risk is if discussions for raising/suspending the debt ceiling gets caught up in, or are used as collateral for bipartisan discussions involving Biden's infrastructure plans, leading to delays. Jitters could start nearer to 31 Jul, if no necessary action is taken, and gradually intensify (but likely not blow up yet) as the treasury switches to extraordinary measures" to sustain government operations.

We do note somewhat greater urgency this time round vs. past years, due to Covid complications. Increasingly, the Treasury is warning that additional spending on Covid-19 relief programmes has added more uncertainty to government payment flows, and federal funds could be exhausted more quickly than previously thought.

Based on debt ceiling related requirements, the Treasury will likely continue to reduce its cash balance to around US$450bn, from around US$733bn in end-Jun. It will have to lower its supply of bills, and add to glut of cash in the front end. Money markets could see modestly greater volatility into end-Jul or Aug if US politicians continue to delay a resolution to the debt ceiling concerns.

On net though, referencing 2019's market reactions, broader/more severe market responses to US debt ceiling concerns could be unlikely. Markets appear somewhat used to brinksmanship by US political parties. A large negative shock in expectations will need to exert itself, i.e., continued impasse or large structural shift in outlook of US spending and deficits, before larger moves in financial markets can emerge. In terms of directional biases, any risk-off surprise in developments could be supportive of the dollar, and lead to a bout of softening in equities. But the political cost to be seen as causing a government partial shutdown or an unthinkable default on US government bonds could be too great.

Box 2: Covid Challenges—Near-Term Covid Risks Rising in Asia, Vaccine Attitudes an Emerging Hurdle for DM Inoculation Progress

We note that markets sentiments, including in FX, were at least tied in part to differential pace of infections and inoculations in 1H 2021. This was discussed in part (I) of this report but we provide a broader overview here. Current assessment of inoculation/infection conditions are colour-coded in table below. Red represents undesirable outcomes while green represents desirable outcomes.

Global Inoculation & Infection Trends

	Inoculation		Infection			
	Inoculation Coverage (% of pop.)		7-day Moving Avg of New Cases		Apr-Early Jul Trend	Characterization
DM	Early Apr	6-Jul	1-Apr	6-Jul		
US	23.6	51.7	65,719	13,611		Easing
UK	27.1	59.4	4,518	26,325		Surge
Canada	7.8	53.4	5,430	473		Easing
Germany	8.3	46.9	17,388	597		Easing
France	8.7	44.6	38,731	2,388		Easing
Italy	8.6	46.4	20,363	796		Easing
Japan	0.4	20.2	2,105	1,632		Easing After Recent Rise
Australia	1.4	16.5	13	37		Risks from New Clusters
New Zealand	0.5	11.7	3	3		Contained
EM						
China	4.2	47.1	11	24		Contained
Singapore	11.6	51.4	22	11		Easing After Recent Rise
Malaysia	1.1	14.3	1,216	6,713		Upticks
Indonesia	2.3	9.0	5,042	26,936		Surge
Thailand	0.1	7.9	64	5,734		Upticks
Philippines	0.3	4.7	9,022	5,396		Signs of Easing
Korea	0.9	20.1	489	827		Upticks
India	2.5	13.2	65,211	42,974		Easing, But Still Elevated

Source: Our World in Data, Bloomberg Vaccine Tracker, Maybank FX Research & Strategy Estimates

On net, **near-term Covid risks in DMs eased in 2Q (except for UK and Australia) while infection risks in ASEAN shows signs of picking up again in 2Q.** This could go some ways in helping to explain the relative outperformance of DM FX vs. AxJ FX in the quarter.

In US and UK, we think that their vaccine leads since 1Q may have been partly priced in prior. Further gains on vaccine progress may be limited. On the other hand, Europe and Canada saw steady progress in vaccine catch-up in 2Q, and benefited from easing Covid case counts. For Australia and New Zealand, key risk is relatively slow inoculation pace.

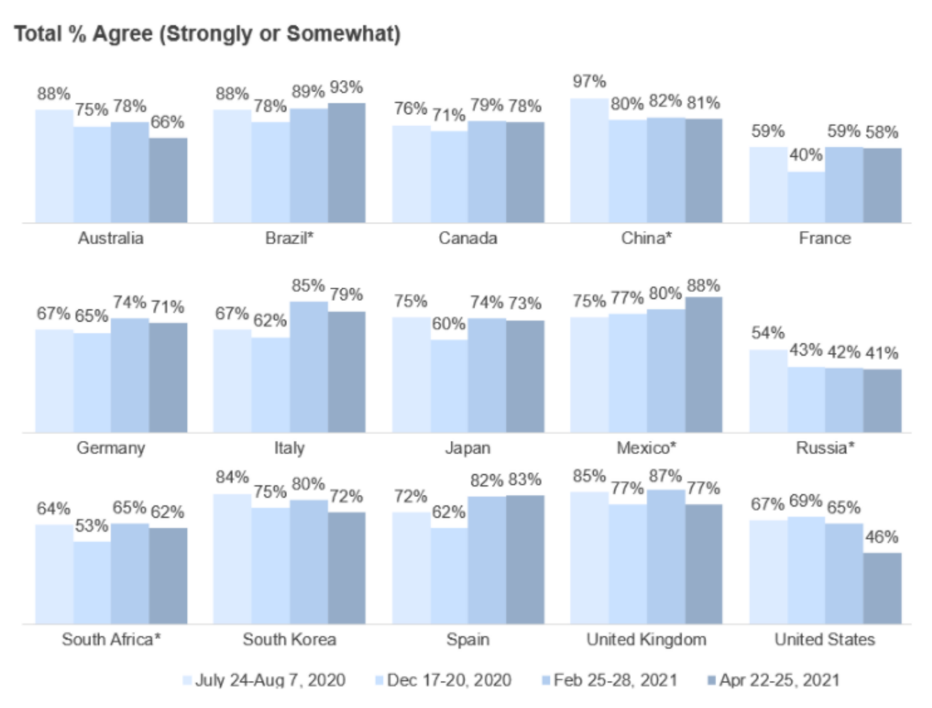
Meanwhile in Asia, China is also catching up steadily on vaccine progress while cases remain low. Singapore maintains lead in ASEAN in vaccination progress and prior concerns over new community clusters seem to have eased. Inoculation in Malaysia has reached double % population coverage but is still lagging most DMs, or neighbours Singapore, Korea. Persistent daily case counts >4k could be a modest drag on sentiments given that one of the key conditions announced for more widespread easing of curbs is for the daily average to fall <4k. For the rest of ASEAN, we note slow inoculation and rising infections in Thailand, Indonesia. The pace of infection spread in Indonesia is particularly worrying, with official counts having quadrupled from early May.

Vaccines Still of Value Despite Mutant Variants; Vaccine Hesitancy Could Slow DM Progress

Even as new variants of the virus pose risks to the resilience offered by herd immunity, the benefits of vaccines in terms of public health and concomitantly, the economy, are still notable. A CDC study in Apr (US) found that vaccines can reduce hospitalization by 94% for adults 65 and older.

Among DMs, there are worrying signs that vaccination pace is slowing in the US as people that are willing to be vaccinated have already stepped forward. Supply has exceeded demand and it could be a challenge to reach an inoculation rate of three-quarters or more. Besides new virus variants, herd immunity in general could be also hard to reach because of vaccine hesitancy, and the lack of vaccine availability for children.

<u>Vaccination Intent Among the Unvaccinated by Country</u>



Source: IPSOS 22-25 Apr 2021 Survey, among 9890 unvaccinated adults

In an Apr IPSOS survey, among adults who have not yet been vaccinated against COVID-19, those who strongly or somewhat agree they would get it make up >50% of the unvaccinated in 13 of the 15 countries surveyed. Exceptions are US (46%) and Russia (41%). Intent to get vaccinated among currently unvaccinated is "very high" in EMs such as in Brazil (93%), Mexico (88%), Spain (83%), and China (81%); "fairly high" in Italy (79%), Canada (78%), Japan (73%), South Korea (72%), and Germany (71%), and "middling" in Australia (66%), South Africa (62%), and France (58%).

Notably, the percentage of unvaccinated adults who strongly or somewhat agree they would get a COVID-19 vaccine has dropped (vs. Feb) in the United States (-19), Australia (-12), the United Kingdom (-10). Results are not strictly comparable across countries as the data will be skewed by current vaccination progress (e.g., the faster the pace of vaccination is in a country, the more likely a larger share of the unvaccinated will be resistant to vaccines). **But still, the results of the survey suggests that challenges associated with vaccination attitudes could be greater for DMs (especially US) compared to EMs or Asia**.

Incidentally, on a forward-looking basis, this could suggest some form of catch-up in Asia (vs. DMs) in both the inoculation pace as well as the accompanying positive sentiment spillovers to risk assets over the next 6-18 months (conditional on current regional wave of new Covid cases easing). One country to watch out for on this front is Philippines, with some polls suggesting that more than half of those surveys may be hesitant about vaccine shots due in part to disinformation on social media.

Within Asia, based on latest available info, our MKE colleagues expect herd immunity could be reached: from 4Q 2021 for Singapore, 1H 2022 for Malaysia and Thailand, 2H 2022 for Indo, Phil, Viet, and 2023 or later for the rest of CLMV. Vaccination progress could be a game-changer for larger domestic markets like Indonesia and Philippines given their high infection rates, allowing the easing of domestic lockdowns. For more open economies dependent on tourism and international people flows, like Singapore and Thailand, vaccine progress could still influence sentiments but the economic benefits from the vaccine could come later as border controls will not be loosened as quickly as local lockdowns and mobility restrictions.

Concluding Remarks

Interim Support for USD but Likely to Fade Into 4Q. In light of Covid spread in the region and Fed shifts, we see some upside room for USD. US Labor-related data, including bumper ADP, 15-month low initial jobless claims, record high new job openings and the recent layoff report showing fewest job cuts since 1997 are consistent with signs of a tightening labor market. With maximum employment one of Fed's dual mandate, stronger jobs data could well build market expectations looking for the Fed to bring forward policy normalisation timeline. This would add to USD strength in the interim. Furthermore light USD positioning could possibly see room for USD longs to build. Elsewhere *delta* variant's rampant spread in other parts of the world including Asia pacific countries is weighing on market sentiment and had prompted some countries and major cities to tighten restrictions/ re-impose lockdowns. Tighter restrictions, extended lockdowns may lead to delays in reopening of economies and with vaccine supply inadequate and inoculation pace lagging for some countries in Asia Pacific region, the USD strength could be a bit more pronounced vs. some AXJ and antipodean FX (risk aversion).

- Based on our study on regional currencies' sensitivity to Fed's shifts (with the use of UST 2Y yield as a proxy for Fed's shifts), IDR, JPY and KRW are expected to be the most vulnerable given potential for carry trades to unwind (for high-yielding IDR) or to flourish (for funding currency JPY). KRW's risk-sensitive nature renders it susceptible to Fed's shifts as well. In contrast, the AAA sovereign credit rating of SGD, AUD and NZD make them comparatively more attractive in a rising rate environment. For CNY, PBoC tends to dampen excessive volatility in the RMB including any Fed-induced taper tantrums or tightening fears, potentially resulting in outperformance against more volatile regional peers.
- Meanwhile, a refresh of our ASEAN FX volatility model suggests that while there may be some modest under-pricing of risks currently (i.e., ASEAN FX vols should be higher than actual at end-Jun given various conditions captured by explanatory variables), the extent of "under-pricing" is likely not excessive at this point. Barring materialization of new negative risk drivers, any bouts of softness in AXJ FX looks less likely to manifest into a severe sell-off tantrum. In particular, we note that CNY volatility (significant at the 1% level in explaining ASEAN FX vols) has declined since Biden won the US elections, and a more stable CNY could be helping to buffer shocks to ASEAN FX.

On net, **a USD smile theory of US data outperformance, policy divergence and risk aversion could keep USD supported for now until we have some visibility from Fed's guidance re. policy normalisation.** We think it is **possible Fed offers some guidance at the upcoming Jackson Hole symposium (26 – 28 Aug) or latest**

by Sep FoMC (22 Sep). Our baseline here assumes gradual tapering to begin in Jan 2022 and to end the $120bn/month QE purchase by end-2022 before tightening rates in 2023. Hence on a USD trajectory basis, we **expect USD to stay supported in the interim for 3Q 2021 before USD strength moderates into 4Q when Fed comes clear on its guidance (assuming no hawkish surprises).** Any **AXJ weakness should then reverse more meaningfully** given 1 less uncertainty. In addition, **it is also likely vaccination pace in Asia could start to catch up from 4Q into 2022 as vaccine supply comes through. Potential reopening of AXJ economies should further help to anchor AXJ strength.**

Favoured FX Plays

On FX tactical cross plays in the interim, we favour long RMB and SGD vs. short IDR and THB (worsening Covid situation – vaccination laggard and Covid resurgence, lockdown risks). Less negative bias for RMB is on the basis that PBoC tends to dampen excessive volatility in the RMB including any Fed-induced taper tantrums or tightening fears and that could potentially result in relative outperformance against more volatile regional peers.

Looking out when Fed's guidance offers greater clarity of policy normalisation, we would be inclined then to sell JPY vs. long KRW, on the back of hawkish BoK, constructive macro fundamentals and semiconductor story.

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