FX Insight

Commodity Exuberance and FX Implications

Between Commodity Exuberance and Inflation Fears

The sharp snapback from a global recession has brought alongside with it a sustained uptrend (thus far) in commodity prices. In this report, we look at some factors that have lifted commodities and why we remain broadly constructive on commodity-linked FX while acknowledging near term risks of correction associated with stretched positions and price action. We also explore how relationships between FX swings and commodity price moves have shifted over time (i.e. does key FX proxies for commodities still work well?) and if markets can deal with higher inflation.

Utilizing 52-week rolling correlations, we find that:

- Crude oil markets could have become a key proxy for global recovery bets, with positive correlation readings strengthening beyond CAD, MYR.
- Copper, iron/steel price moves are still significantly positively correlated with swings in DM commodity-linked FX, as global infrastructure spending plans get underway. Correlations with AxJ FX are more mixed.
- Within AxJ, SGD and KRW remain as the top proxies for tech trends, maintaining elevated correlations with chip prices.
- Price moves in CPO and agricultural products (foodstuffs) are less associated with FX swings. But to some extent, robust CPO prices could have been supportive of IDR sentiments in recent months.
- USD is now more negatively correlated (vs. historical) with commodity price moves. This likely goes beyond conventional "USD benchmark pricing" effects (i.e. incremental demand on "cheaper" commodities when USD falls), with dollar's countercyclical tendencies seemingly emerging more strongly.

One challenge for markets and EM FX is how inflation evolves (much faster pace of increase than expectations or more persistent upticks) and market expectation on Fed's monetary response. Fed's dovish reassurance that it will not jump the gun and to be behind the curve with regards to policy normalisation/ tapering of bond purchases is key. A continuation of current dovish rhetoric for a few months may present a window for UST yields to ease further, alongside lower USD. This scenario could pan out if US CPI, activity data coming on-stream turns out to be "less hot" than expected.

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52-Week Rolling Correlations Btw FX Changes and Commodity Price Changes

	Brent		CPO		Copper		Iron/Steel		Foodstuffs		Chips	
	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21
DXY	-0.17	-0.28	-0.05	-0.25	-0.35	-0.55	-0.15	-0.27	-0.21	-0.31	-0.27	-0.53
AUD	0.22	0.45	-0.01	0.18	0.53	0.59	0.36	0.45	0.19	0.22	0.55	0.55
NZD	0.16	0.46	-0.02	0.21	0.45	0.62	0.27	0.29	0.20	0.23	0.49	0.46
CAD	0.42	0.44	0.07	0.23	0.45	0.55	0.35	0.56	0.22	0.27	0.43	0.55
CNH	0.16	0.23	-0.07	0.26	0.50	0.52	0.31	0.29	0.23	0.22	0.46	0.47
KRW	0.11	0.27	0.04	0.05	0.50	0.37	0.29	0.24	0.12	0.13	0.54	0.51
SGD	0.21	0.29	0.03	0.13	0.50	0.51	0.27	0.20	0.20	0.24	0.46	0.55
MYR	0.20	0.34	0.11	0.03	0.34	0.36	0.31	0.11	0.23	0.16	0.38	0.33
THB	0.21	0.24	0.12	0.10	0.37	0.24	0.09	0.06	0.10	-0.11	0.33	0.25
IDR	0.16	0.49	0.05	0.24	0.40	0.35	0.25	0.30	0.15	0.29	0.51	0.47
PHP	0.07	0.40	-0.03	0.08	0.15	0.24	0.22	0.38	0.02	0.08	0.29	0.40

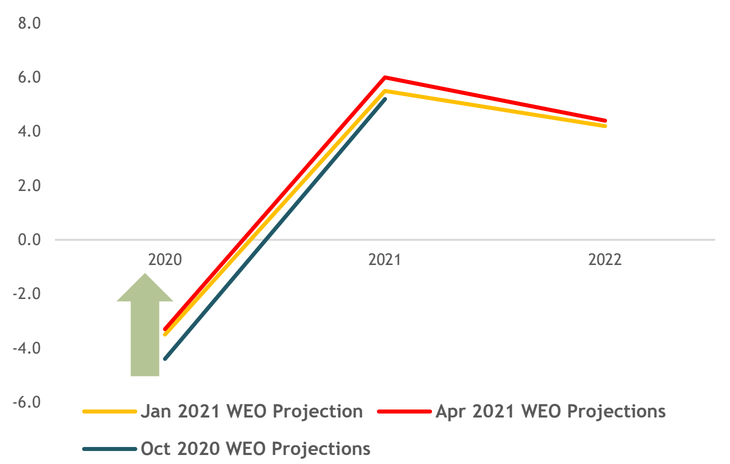
Note: Iron/steel prices are proxied by the TOPIX iron & steel index, semiconductor chip prices are proxied by the Philadelphia stock exchange semiconductor index, while foodstuffs prices are proxied by the Commodity Research Bureau Foodstuffs index comprising components such as hogs, steers, lard, butter, soybean oil, cocoa, corn, wheat, sugar etc.
Source: Bloomberg, Maybank FX Research & Strategy Estimates

The Commodity Boom and FX Implications

(I) Keeping Our Constructive Bias on Commodity-Linked FX

The world had witnessed the sharpest snapback from a global recession as governments and central banks provided swift backstops to financial markets and strong stimulus packages to the economy in response to the pandemic. Into 2021, additional fiscal support were provided in countries such as the US, China and Canada, boosting economic outlook for the year. Along with faster than expected mass vaccinations in some countries, IMF had multiple upgrades in growth forecasts over the past few months. In its latest World Economic Outlook (Apr), 2021 World output forecast was raised to 6.0% from 5.5% prior, led by China and the US.

Accelerated Recovery Spurred Multiple Growth Upgrades by IMF



Note: 2022 Would Output Projection was not available in the Oct 2020 WEO
Source: IMF World Economic Outlook (WEO), Bloomberg, Maybank FX Research & Strategy

Recent Covid Risks May Not Derail Commodity Demand

Comparing inoculation-infection trends, we assess whether recent Covid waves around the world show signs of derailing commodity demand.

Europe Catch-up in Inoculation, Global Covid Wave Shows Signs of Easing

	Inoculation		Infection			
	Inoculation Coverage (% of pop.)		7-day Moving Avg of New Cases		Mar-Early May Trend	Characterization
DM	Early Mar	11-May	Early Mar	11-May		
US	11.6	41.0	67,470	38,135		Signs of Easing
UK	15.8	40.2	7,980	2,271		Easing
Canada	2.6	21.9	2,968	7,089		Stabilize After Recent Rise
Germany	3.8	21.5	8,010	13,658		Signs of Easing
France	4.2	20.6	21,549	17,113		Signs of Easing
Italy	3.8	20.7	17,073	9,058		Easing
Japan	0.1	1.9	1,008	5,649		Rising
Australia	0.1	5.4	7	12	*Neg.*	Contained
New Zealand	0.1	3.1	3	2	*Neg.*	Contained
EM						
China	1.9	11.9	29	10	*Neg.*	Contained
Singapore	4.6	27.5	10	22		Rising Community Clusters
Malaysia	0.1	2.8	2,403	3,975		Rising
Indonesia	0.5	4.1	7,497	5,318		Signs of Easing
Thailand	0.1	1.4	75	2,019		Stabilize After Recent Rise
Philippines	0.1	1.0	2,132	6,522		Signs of Easing
Korea	0.2	4.1	384	568		Stabilize After Recent Rise
India	0.6	6.4	15,442	387,098		Surge, But Losing Momentum

Note: Red represents undesirable outcomes while green represents desirable outcomes. Data extracted as of 12 May.
Source: Our World in Data, Bloomberg, Maybank FX Research & Strategy Estimates

From Mar to early May, the US and UK extended gains in their vaccine lead, while catch-up progress in inoculation is particularly discernible in Canada and Europe. Add to that signs of stabilization in new Covid cases in Canada and broad signs of easing in contagion in Germany, Italy, France, and these DM economies managed to see their macro recoveries largely avoid being derailed. For Australia and New Zealand, while vaccine population coverage remains at low single-digit percentages, this is likely more than made-up for by domestic contagion risks remaining largely under control.

Back in Asia, the Chinese economy continued to benefit from double positives of steady vaccination progress as well as negligible Covid cases, a remarkable feat given its large populace. As a result, demand conditions across a wide swathe of indicators (PMIs, trade, retail sales, investment) remained largely robust.

While sentiments in ASEAN were more cautious over Mar-Apr, on vaccine shortages and spikes in Covid cases (notably Malaysia, Thailand, Philippines), signs are that the earlier uptrend in new cases in Thailand and Philippines seem to be tapering off. In Malaysia, the rise in new cases thus far remains below the Feb peak and has hopes of being contained alongside new MCO curbs. In Singapore, we note nascent re-emergence of community clusters tied to the more infectious B1617 mutant variant, but authorities have also acted swiftly to re-introduce targeted social curbs with expected minimal impact to economic activity.

To some extent, developments in India remain the most worrying. 7-day average in new cases has surged from around 11k in mid-Feb to around 387k on 10 May. The second wave of COVID infections could derail prior strong recovery momentum in the Indian economy. S&P ratings, which in March had seen Indian GDP growing by 11% in the FY to March 2022, assessed that GDP growth could come in at 9.8% under a "moderate" scenario where infections peak in May, and potentially fall to 8.2% under a "severe" scenario where contagion would peak only in late June.

On net, recent intermittent Covid waves (first in Europe, then in Asia) appear to have resulted in modest speed bumps to demand conditions, rather than derail the growth recovery narrative. Even in countries where partial curbs were implemented, economic activity saw a significant degree of adjustment to the targeted restrictions, and macro data readings remained largely resilient.

As a result, structural demand for commodities should not see a significant dampening effect from near-term Covid risks. If regional inoculation trends (ASEAN, Australia, New Zealand) pick up from low bases, developments could be further supportive of current ongoing recovery momentum.

The Rush to Greener Economies – Electric Vehicles at the Forefront

In addition, the pandemic also inspired greater global efforts on sustainability and countries focus on mass adoption of electric vehicles as one of their nearer-term priorities to reduce carbon emission.

Country	Climate Change/ Electric Vehicle Aspirations	To Achieve by
US	Biden proposed a $174bn investment to "win the EV market" that includes building 500,000 EV chargers across the US, replacing current diesel-powered transit and school buses to electrically charged ones.	2030
UK	Sale of petrol and diesel-powered cars is prohibited	2030
Germany	The government extended EV subsidies last Nov 2020 by a further 4 years to 2025.	2025
China	China ordered all automakers to have electric vehicles make up 40% of all sales by 2030 and all new vehicles sold to be "eco-friendly"	2030
Thailand	Thailand aims to sell only zero-emission vehicles	2035
Singapore	Singapore aims to phase out Internal Combustion Engine Vehicles for a switch to electric vehicles. The government announced deployment of 60,000 charging points at public car parks and private premises by 2030 and also launched a EV Early Adopter Incentive.	2040

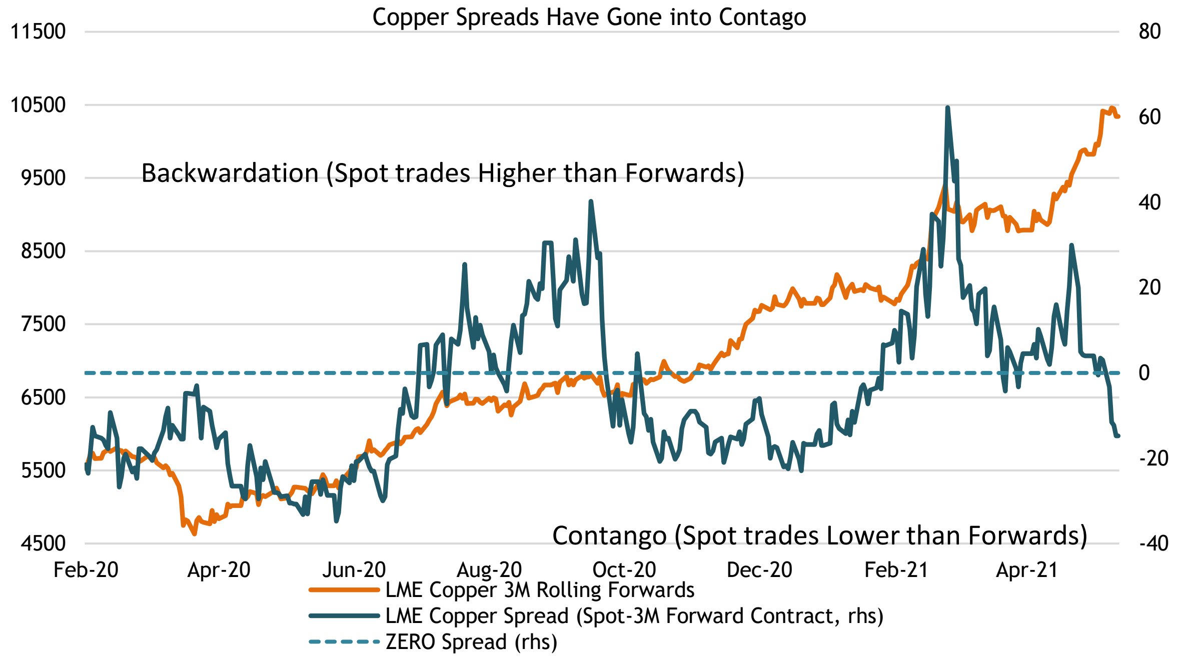
Source: Various News Sources

Some auto producers have also pledged to stop producing petrol and diesel-powered vehicles including Jaguar (2025), General Motors (2035), Bentley (2030) and Volvo (2030). Given the sovereign push for greener economies and electric vehicles, there is a surge in demand for certain industrial metals that are key to these sustainability endeavours. **Industrial metals such as copper, nickel and aluminium are classified as commodities of the future, according to Fitch Solutions.**

Source: Fitch Solutions

Copper has become a focus because of its function in electric vehicles and their charging stations. Chile and Peru are the top copper producing countries in the world but local COVID-19 infections and concomitant government-imposed lockdowns have affected copper productions, resulting in a supply and demand gap. The 3-month rolling forward LME copper price rallied above the $10,400/MT-level before softening recently. Copper spreads (cash-to-three month forward prices) have gone into contango (spot prices trade below three months forward) and that could translate into a pause in the recent rally. This could the first sign of a potential correction in the recent rally of base metals. Iron ore prices too had seen a tentative pullback after steel-producing hub of Tangshan prohibited steel producers from spreading information on price-hikes. The authorities in Tangshan warned of license revocations for offenses such as price manipulations, in line with President Xi's concerns about rising commodity costs.

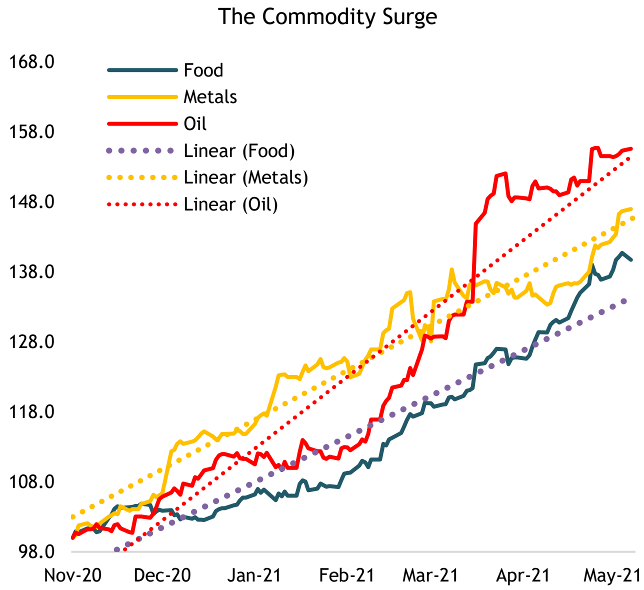
Copper Spreads have Gone into Contango Which Could mean Slower Increases

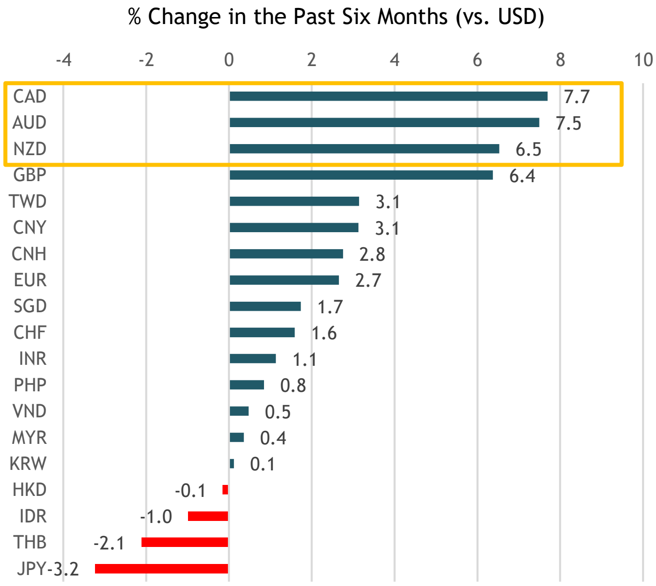


Source: Bloomberg, Maybank FX Research & Strategy

Apart from green initiatives, countries such as the US, Australia and Canada have taken the opportunity to reinvest in their rail and roads infrastructure in 2021. A combination of infrastructure reinvestment and eager green endeavours saw commodity prices surge on seemingly insatiable structural and cyclical demand, taking AUD, NZD, CAD higher vs. the USD and other peers. We remain particularly bullish on the AUD given its inextricable fate with base metals. Australia produces half of the world's lithium (world's largest), world's largest nickel reserves (24% of total reserves) and third biggest reserves of copper. Sustained growth in the demand for these base metals bodes well for its terms of trade.

AUD, NZD, CAD Outperform As Commodity Prices Surge.





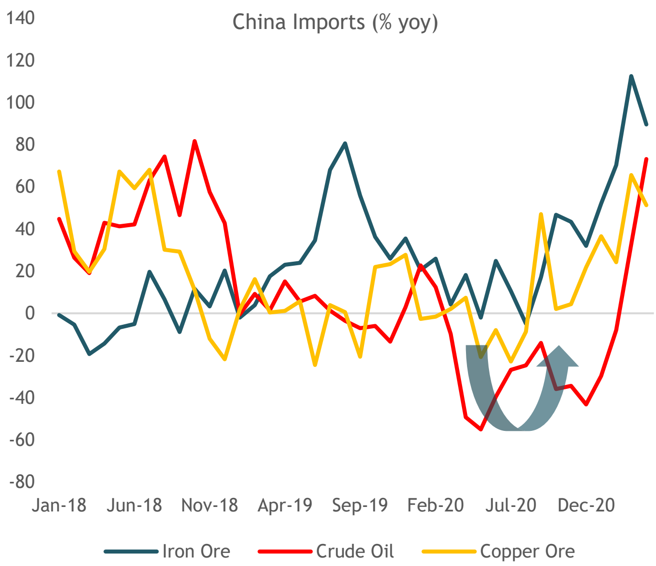
Note: LHS Chart shows CRB Index for foodstuffs, spot metals and oil with 100 = 4 Nov 2020 (6 months performance)
RHS Chart shows respective currency performance against USD between 10 Nov 2020 – 10 May 2021.
Source: Bloomberg, Maybank FX Research & Strategy

Demand Was First Seen in China, the US to Follow

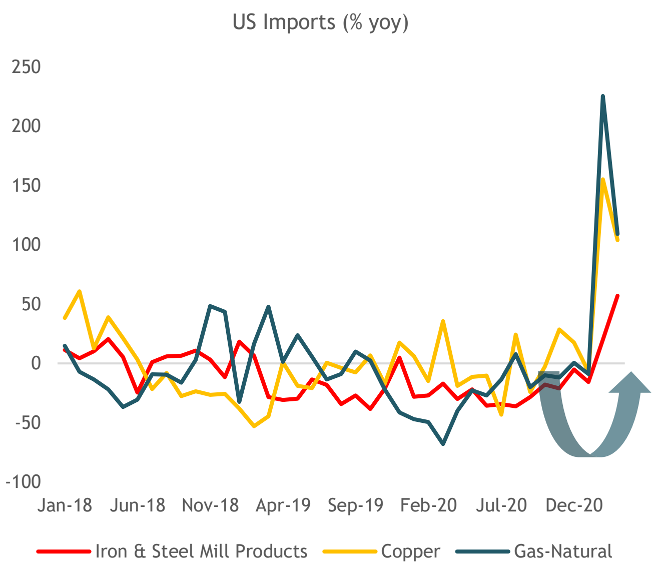
Given that China was the first major economy to emerge from the pandemic, its demand for raw materials (metals and fuels) started earlier in 2020. Even at this point, there are little signs that imports have started to taper.

The Rise in Commodity Imports for China Seems Sustained While the Jump in Industrial Imports for the US is only Beginning

China's Thirst for Commodities Remain on the Rise



The US Too Has Substantial Raw Material Imports

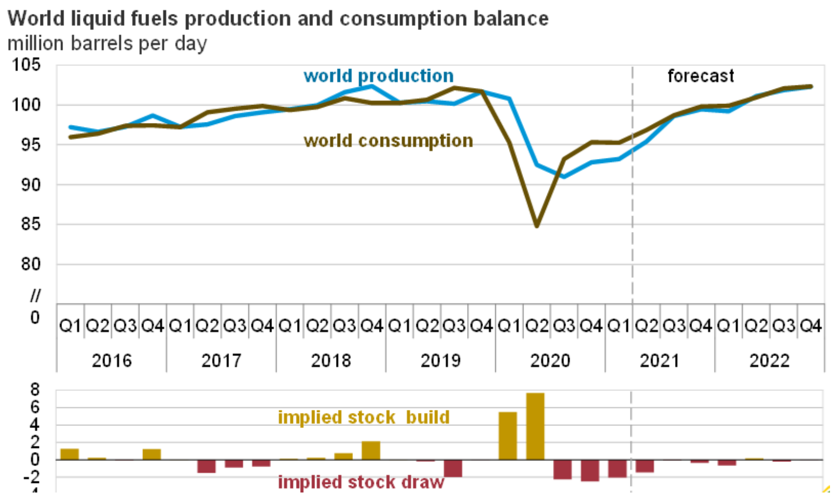


Source: US Censure Bureau, China General Administration of Customs, Maybank FX Research & Strategy

In the US, there was a sharp jump in the imports of industrial supplies (iron, steel products, copper and natural gas) at the start of 2021 and this may just be the beginning given its plans for infrastructure rebuilding that also encompasses green initiatives. Insofar, the recovery has begun in the US and China as pandemic management and mass vaccination made substantial progress there. The demand for base metals and fuel could still gather further momentum as recovery in the rest of the world gains traction.

The US EIA projects gradual increase in world demand for liquid fuel over the next two years and a mild implied stock draw which should translate into small crude oil gains. Oil-linked MYR and CAD should continue to benefit in such an environment.

EIA Projects A Gradual Increase in World Demand for Liquid Fuel into 2022



Source: US EIA, Short-Term Energy Outlook, April 2021

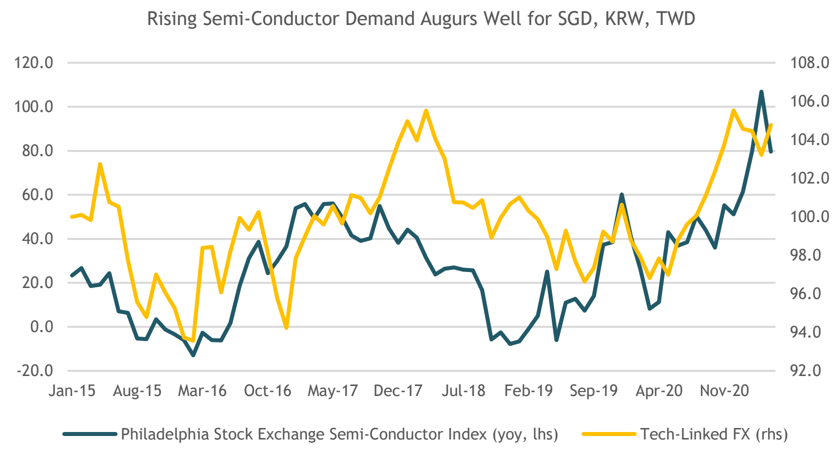
The Semiconductor Shortage

This recession was unique because of the supply disruptions caused by the lockdowns in multiple economies. The result is an acute shortage of semi-conductor chips that were critical to the manufacture of phones, computers, home appliances and cars. Semiconductor equipment supplier ASML expects this pent-up demand to taper only in 2022 while Dell Chief Executive Michael Dell expects shortage to persist several years. Regardless, this acute chip shortage underscores the fact that supply has not caught up in demand and that the cyclical upswing of the semi-conductor industry could extend, auguring well for tech-linked KRW, SGD and TWD.

"The pent-up demand from the ongoing global semiconductor shortage will taper next year…"

ASML Apr 2021

Strong Chip Gains is A Reflection of Strong Demand and Supply Shortage



Note: Tech-Linked FX is an equally-weighted index consisting of SGD, KRW and TWD vs. the USD (the index of 100 = 4 Nov 2020)
Source: Bloomberg, Maybank FX Research & Strategy

The 2020 recession was because of voluntary shutdowns in economies that caused supply disruptions. The resulting surge in commodity prices was all the more exacerbated when government and central banks across the world went full throttle on stimulus and green initiatives, creating supply-demand gaps for base metals and semi-conductor chips. We remain sanguine on cyclical FX, barring potential intermittent pullbacks, as the global recovery remains vastly uneven and re-opening of more economies could only mean greater demand for these commodities.

(II) Shifts in Commodity-FX Correlations?

As discussed prior, global commodity demand and supply in 2Q 2020 saw a sharp negative shock at the onset of the pandemic, as supply chains got disrupted and consumer demand severely dampened on lockdowns. Prices have swiftly recovered since, but it is less clear whether/how relationships between certain commodity complexes and FX moves have shifted over this period.

In this section, **we utilize 52-week rolling correlations to investigate these shifts**. We also include semiconductor chips as a "commodity" given recent market interest in the tech cycle. Given the multitude of drivers inducing FX moves during the Covid period, these readings are meant to distil broad trends instead of identifying specific FX sensitivities. **The underlying premise here is that if correlations are strongly positive, there is an added incentive to be long (or buy-on-dip) certain FX if the optimistic commodity outlook holds**.

Correlations are computed between % changes in xxx-USD pairs (except for DXY) and % changes in selected commodity prices. 3-year average in the table below refers to the average of rolling correlations computed over May 2018 to Apr 2021.

<u>52-Week Rolling Correlations Btw FX Changes and Commodity Price Changes</u>

	Brent		CPO		Copper		Iron/Steel		Foodstuffs		Chips	
	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21	3Yr Avg.	May-21
DXY	-0.17	-0.28	-0.05	-0.25	-0.35	-0.55	-0.15	-0.27	-0.21	-0.31	-0.27	-0.53
AUD	0.22	0.45	-0.01	0.18	0.53	0.59	0.36	0.45	0.19	0.22	0.55	0.55
NZD	0.16	0.46	-0.02	0.21	0.45	0.62	0.27	0.29	0.20	0.23	0.49	0.46
CAD	0.42	0.44	0.07	0.23	0.45	0.55	0.35	0.56	0.22	0.27	0.43	0.55
CNH	0.16	0.23	-0.07	0.26	0.50	0.52	0.31	0.29	0.23	0.22	0.46	0.47
KRW	0.11	0.27	0.04	0.05	0.50	0.37	0.29	0.24	0.12	0.13	0.54	0.51
SGD	0.21	0.29	0.03	0.13	0.50	0.51	0.27	0.20	0.20	0.24	0.46	0.55
MYR	0.20	0.34	0.11	0.03	0.34	0.36	0.31	0.11	0.23	0.16	0.38	0.33
THB	0.21	0.24	0.12	0.10	0.37	0.24	0.09	0.06	0.10	-0.11	0.33	0.25
IDR	0.16	0.49	0.05	0.24	0.40	0.35	0.25	0.30	0.15	0.29	0.51	0.47
PHP	0.07	0.40	-0.03	0.08	0.15	0.24	0.22	0.38	0.02	0.08	0.29	0.40

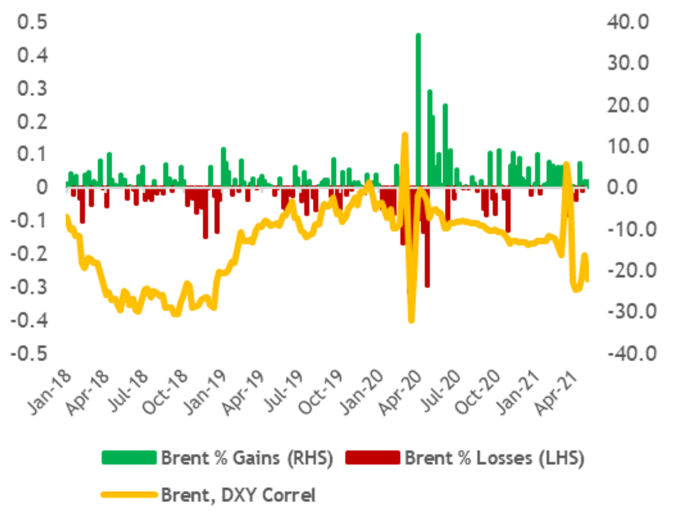
Note: Iron/steel prices are proxied by the TOPIX iron & steel index, semiconductor chip prices are proxied by the Philadelphia stock exchange semiconductor index, while foodstuffs prices are proxied by the Commodity Research Bureau Foodstuffs index comprising components such as hogs, steers, lard, butter, soybean oil, cocoa, corn, wheat, sugar etc.
Source: Bloomberg, Maybank FX Research & Strategy Estimates

Some key observations follow.

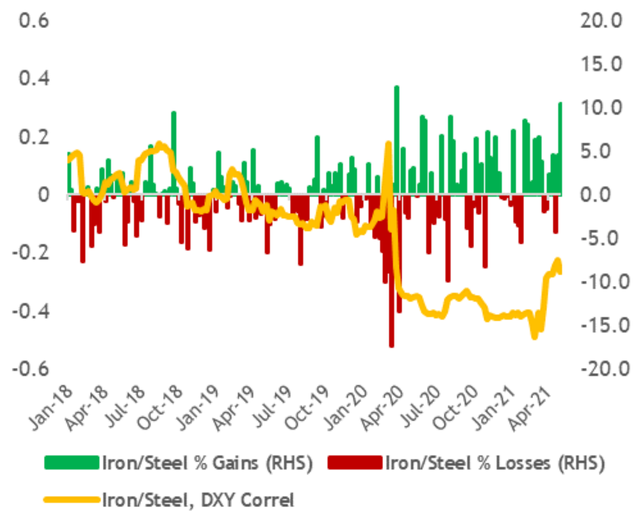
(i) USD Now More Negatively Correlated with Commodity Prices

The well-known negative correlation between USD (DXY) and commodity prices have gotten more negative across most commodity classes. Conventionally, a softer dollar supports incremental demand for commodities at the margin (i.e., cheaper local prices for commodities with USD-denominated pricing when USD softens). But the magnitude of changes in correlation readings (significantly more negative vs. historical) suggests that what we are observing may go beyond "USD benchmark pricing" effects. One possibility could be that dollar's countercyclical tendencies are emerging more strongly. I.e., **USD tends to soften over periods when synchronous global growth momentum is sustained, and this is consistent with an environment where broad vaccine optimism and elevated fiscal spending plans are helping to boost commodity prices.**

<u>Dollar's Negative Correlation with Commodities Re-emerged During the Pandemic</u>



Source: Bloomberg, Maybank FX Research & Strategy Estimates



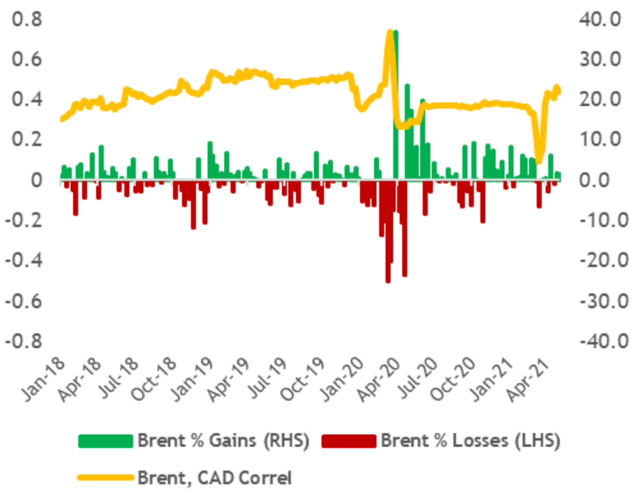
Source: Bloomberg, Maybank FX Research & Strategy Estimates

(ii) Most FX Saw Positive Relationships with Crude Oil Strengthen

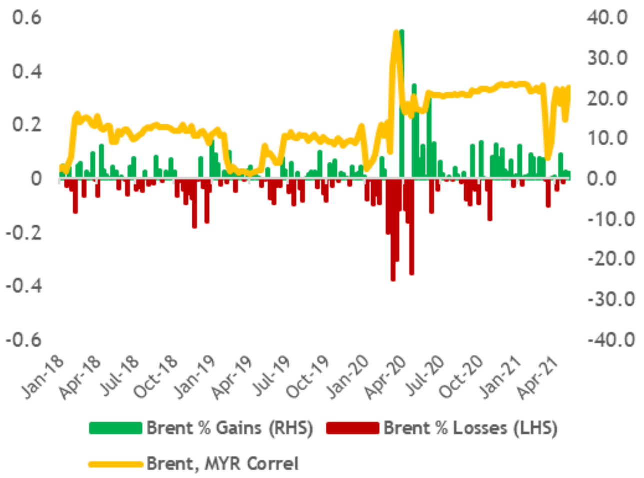
For Brent, its positive correlation with most FX intensified, including FX of key oil exporters Canada and Malaysia.

Nonetheless, **the strengthening of the positive associations seems to be a more broad-based phenomenon**. We postulate that **crude oil markets could have become a key proxy for global demand recovery bets**, adjusting to broader information flow including Covid contagion trends, lockdowns/re-openings etc.

CAD Maintained Significantly Positive Correl. with Oil; MYR's Interdependence with Oil Strengthened



Source: Bloomberg, Maybank FX Research & Strategy Estimates



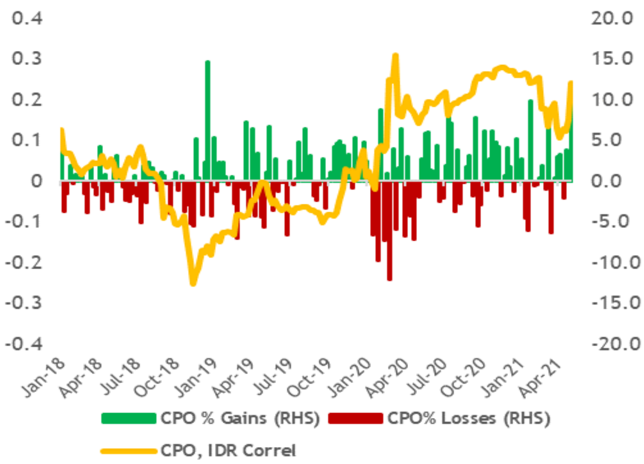
Source: Bloomberg, Maybank FX Research & Strategy Estimates

(iii) Crude Palm Oil Now Mildly Positively Correlated with Non-USD FX

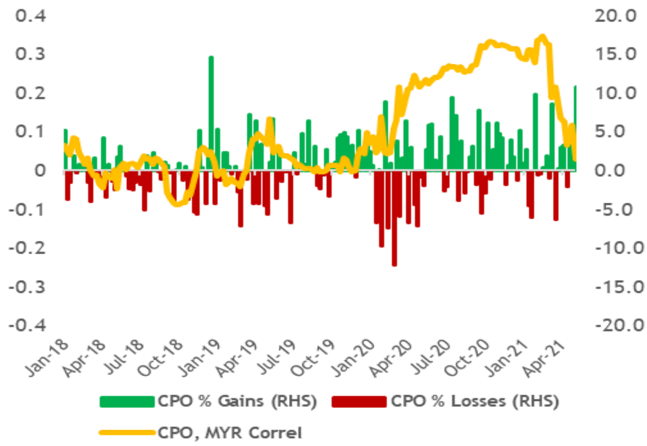
For CPO, correlations seem to have inched up slightly (skewed to positive bias now) versus more neutral readings historically. Among ASEAN FX, **IDR could be seeing discernibly more support from CPO price increases lately**. Palm oil is Indonesia's top export and accounted for roughly 11% of Indonesia's total exports in 2020. YTD gains of >20% in CPO prices could have helped to mitigate IDR losses induced by higher UST yields. Despite an almost 70bps spike in US10Y yields disrupting the portfolio flow recovery, IDR is only down by around 1% YTD.

Malaysia is one other key exporter of CPO. From the table above, we note that the most recent correlation reading for MYR-CPO is not significantly positive. From the rolling correlation chart below (LHS), we note that there were indeed tentative signs of moves in MYR and CPO becoming more interdependent from Apr 2020 to Mar 2021, but this positive association dampened significantly over the Apr-May 2021. MYR sentiments had likely turned more cautious alongside the recent Covid wave (and concomitant curbs), even as CPO prices largely pushed higher.

<u>IDR's Correl. with CPO Strengthened; Similar Trend for MYR Disrupted by Recent Covid Wave?</u>



Source: Bloomberg, Maybank FX Research & Strategy Estimates



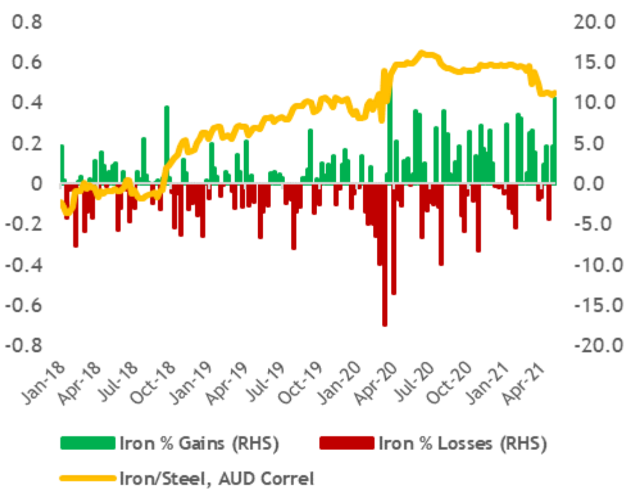
Source: Bloomberg, Maybank FX Research & Strategy Estimates

(iv) Copper, Iron/Steel More Positively Correlated with DM Commodity-linked FX, Maintain Positive Associations with AxJ FX

For metals Copper and Iron/Steel, the broad picture looks similar. Correlation readings suggest that modest positive relationships between these metals and AxJ FX (both are indicators of procyclical trends) have largely remained unchanged versus historical.

Meanwhile, their positive correlations with DM commodity-linked FX such as AUD, NZD and even CAD, have strengthened further versus historical, albeit showing signs of dipping from recent highs. In particular, Australia's role as a key exporter of iron ore and copper could be boosting AUD strength as major economies embark on infrastructure spending plans as part of post-pandemic support stimulus, and various economies push EV initiatives.

<u>Swift AUD Recovery Post Covid Onset Supported by Rising Interdependence with Iron, Copper</u>



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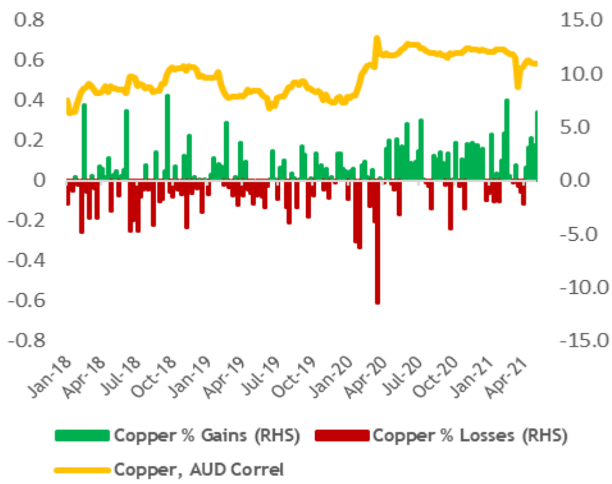


Source: Bloomberg, Maybank FX Research & Strategy Estimates

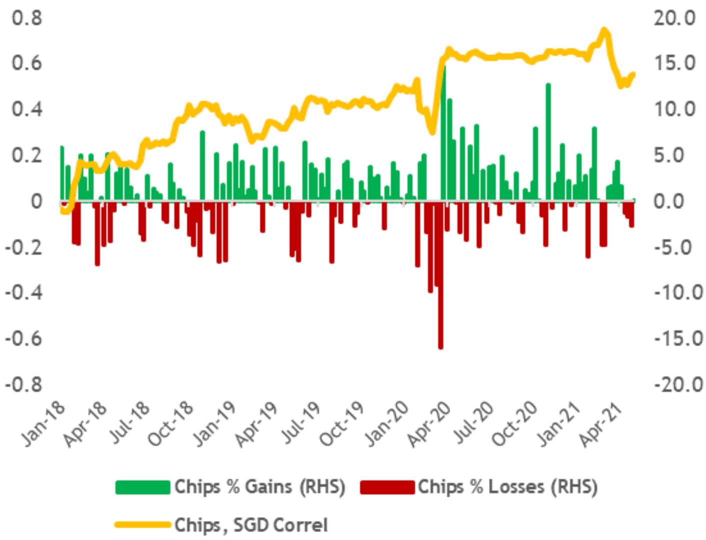
(v) Agricultural Exports Likely Not a Key Driver of FX Moves

For foodstuffs, while agricultural products continue to maintain mildly positive associations with most FX (except USD), **no discernible structural shift is observed.**

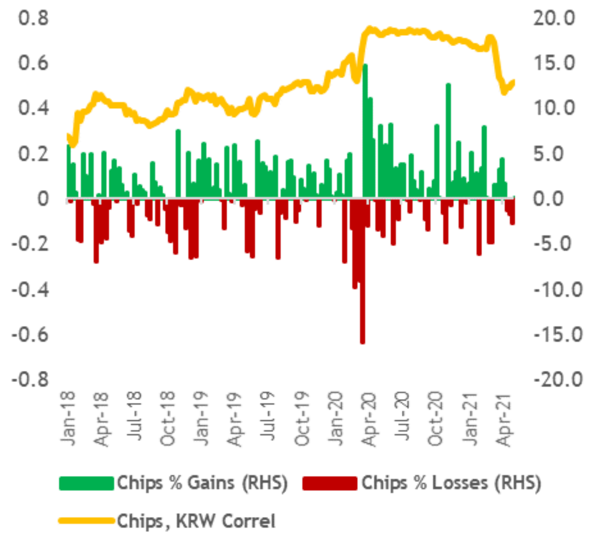
(vi) Among AxJ FX, SGD, KRW Retain Usefulness as Tech-Linked Proxies

For semiconductor **Chips**, significant positive correlations with most FX are observed, even during pre-Covid times. **Among AxJ FX, the magnitudes of the positive correlations are currently highest for KRW and SGD, both commonly viewed as tech-linked proxies.** We also note THB as a laggard in benefiting from broader tech demand, with key THB sentiments in the interim likely tied to the pessimistic global tourism outlook.

Correlations Between Chip Price Changes and SGD, KRW Moves Still Elevated



Source: Bloomberg, Maybank FX Research & Strategy Estimates



Source: Bloomberg, Maybank FX Research & Strategy Estimates

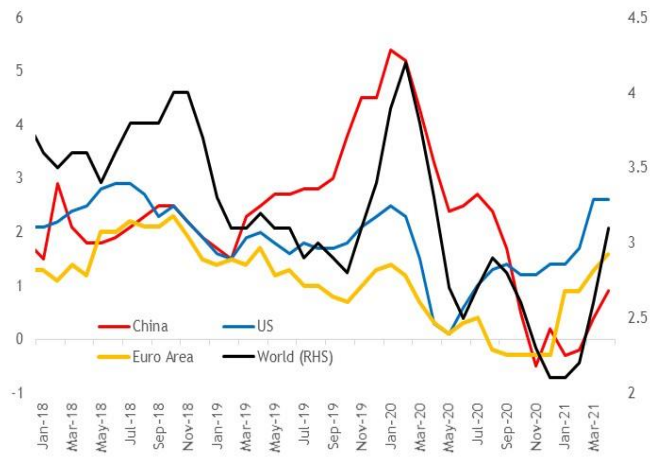
(III) Can Markets Deal With Higher Inflation?

"Nothing to Fear but Fear (of inflation) itself"

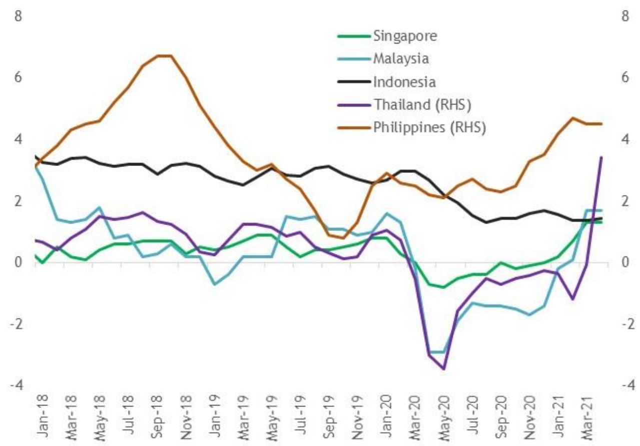
- Adam Posen,
President of the Petersen Institute for International Economics

Markets have seen higher volatility across multi-asset classes, sharp rise in UST yields in the early part of the year following the turnaround in global CPIs and continued rise in commodity prices. Global CPI started to turn around in Jan-Feb 2021 from around 2.1% and has since continued to rise to 3.2%. A similar pattern in pace of pick up in headline CPIs was also observed for US, China, and ASEAN including Singapore, Malaysia (though timing of inflection may differ). For Indonesia, headline CPI has been relatively subdued, partly due to prolonged restrictions hampering economic growth momentum while energy prices in Indonesia was shielded from rising global oil prices due to fuel subsidies. For US, headline CPI rose 4.2% y/y in Apr, its fastest pace since Sep 2008 as covid-related measures were gradually scaled back, energy prices jumped and on low base effects. For the remaining of the section, we explore the underlying factors driving inflation, markets' expectation for inflation, how Fed's dovish messaging can reassure markets (to some extent) and what scenarios may be negative or positive for risk FX proxies.

CPIs of Major Economies Turning Higher



Indonesia Lags Other ASEAN on Price Pressures

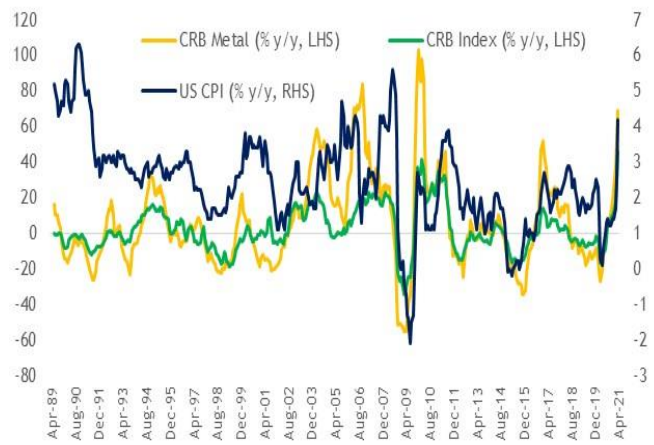


Source: Bloomberg, Maybank FX Research & Strategy

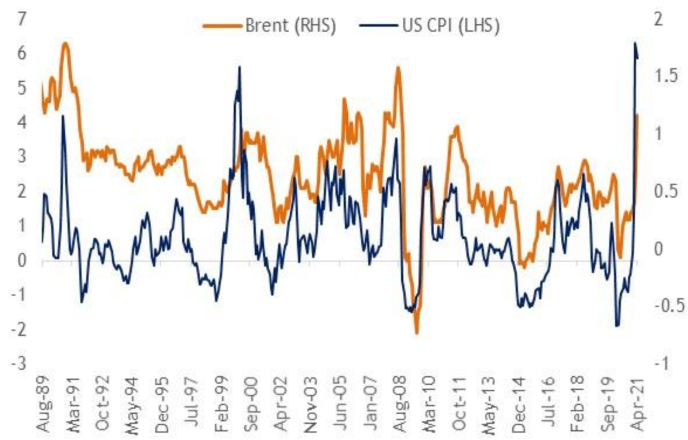
Price Upticks May Persist for A Little Longer

Higher inflation thus far was due to low base effects, ongoing commodity and semiconductor price increases, higher freight charges amid strong demand, higher activity and supply chain disruptions. These **factors may persist in the interim but should eventually fade beyond the next few months.**

Broad Commodity, Metal Prices and US CPI Moving Closely



Brent Crude and US CPI Moving In Tandem



Note: Commodity Research Bureau (CRB) index comprises a basket of 19 commodities including energy, agricultural, industrial and precious metals. It is a aggregated price direction of key commodity sectors

Source: Bloomberg, Maybank FX Research & Strategy

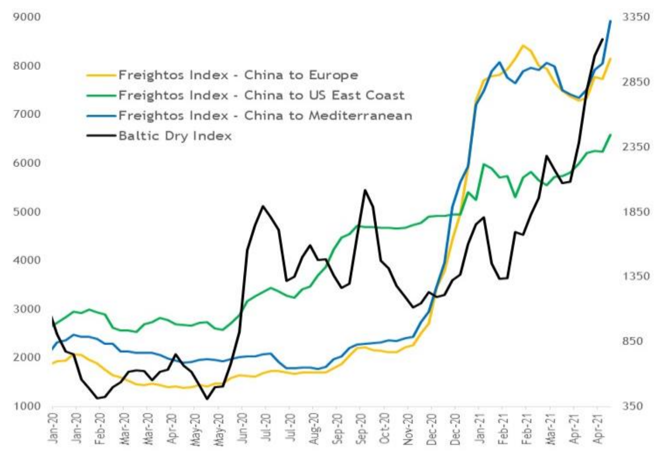
Correlation between commodity prices and US Inflation Picks Up

Note: Correlation are computed between % changes for CRB index, CRB – metal index and Brent over US CPI
Source: CRB, Bloomberg, Maybank FX Research & Strategy

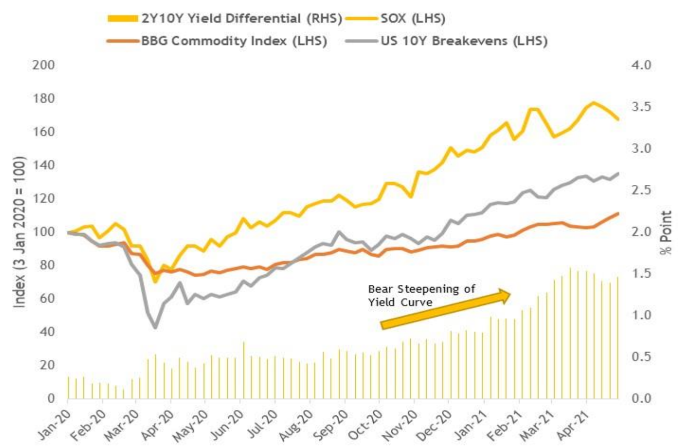
In particular global demand and supply imbalance in industrial metals as well as semiconductor chips is expected to persist for a few more months given low inventories and increasing capacity takes time. **If we look at the semiconductor space, demand is coming from multiple sectors including automobiles to consumer electronics, smartphones, cloud computing, etc. but global shortage in chips is expected to last till early 2022 as most foundries are operating at or above 90% utilization and it will take time to fulfil orders.** Cisco CEO expects global chip shortage to be impacting global supply chains for another 6 months before demand - supply imbalance improves over the next 12 to 19 months as capacity comes on -stream. TSMC expects shortage to continue through 2022 while AMD also expects shortage to impact the industry for a while longer.

Freight charges are also soaring amid rebound in economic activity, combined with covid-19 pandemic-related disruptions to shipping lines and bottlenecks at ports. Baltic Dry index (a composite measure of rates charged by capsize, panama and supramax vessels to ferry dry bulk commodities) is typically used as a leading indicator for global demand for commodities and raw materials and is also a proxy and compelling indicator for global growth, had risen to 10-year high of above 3,200 levels. YTD, the index was up nearly 140% YTD, and was up over 700% since May-2020 low. Another real time measure, the Freightos Baltic index (provides 40' container (FEU) indices for ocean freight based on aggregated and anonymized real time business data from global freight carriers, forwarders and shippers that use WebCargo by Freightos' freight rates management platform) show freight costs of different shipping routes rising to their respective highs amid strong demand and scarce capacity.

Higher Freight Costs May Persist Before Fading



Uptrend in Semiconductor Chips, Commodity Prices Intact



Note: SOX, BBG Commodity Index and US 10Y Breakevens normalized to 100 on 3 Jan 2020
Source: Freightos Baltic Index, Bloomberg, Maybank FX Research & Strategy

Markets Acclimatizing to Slightly Higher Inflationary Environment?

Even with higher inflation and UST yields, albeit from low bases, asset markets including S&P 500, DJIA and commodity prices were printing fresh highs, prior to the recent sell-off. Bond markets were largely stable. Long term yields (beyond 10y) have somewhat eased after the initial rise in Mar-2021 even though inflation expectation (via market measure of inflation breakevens) continue to indicate market expectations for higher inflation (10y breakeven at 2.52%).

Markets' Expectations for Inflation Remain on the Rise

Source: Bloomberg, Maybank FX Research & Strategy

In the FX space, DXY is near recent lows of 90.3-levels while EUR and GBP are near their 2021 highs. Commodity FX are amongst the outperformers (on 6-month time horizon). Asian FX performance was somewhat more mixed and to some extent, lagged DM and North Asian FX. This can partly be attributed to covid-19 pandemic as some in this region do not have as much access to vaccine supply relative to their DM counterparts while some countries in the region such as Singapore and Malaysia have seen a recent resurgence in infection. For Indonesia and Philippines, there are tentative signs of the infection slowing down in recent days, and it is no coincident we are seeing sharp rise in IDR and PHP (at multi-year highs vs. USD).

Fed's Dovish Messaging Can Help to Reassure Markets

Fed's shift towards **Average Inflation Targeting (AIT) regime, tolerance for inflation overshoots and recent dovish messaging from different Fed officials also played a key role in reassuring markets** that Fed was nowhere close to normalizing policies.

Recent Fed speaks and FoMC minutes underscored Fed's commitment to its dovish and patience stance. In particular, Fed officials downplayed inflation concerns, and stressed the need for aggressive monetary policy support as the US economy recovers from the health pandemic, even as the outlook improves amid vaccine rollout. Some notable highlights of recent Fed speaks include:

- Vice-Chair Clarida said (5 May) that "that the data is telling us now is there is going to be some upward movement (on CPI) as we reopen but that it won't persist over a long period of time" and that "we're still a long way away from our goals";

- Fed's Mester said (11 May) she expects inflation to rise above 2% target this year before moving back down in 2022 and this increase will not be considered a sustainable increase that is needed to meet forward guidance on policy rate;

- Barkin said (3 May) that we have an outcome-based policy and when the outcomes look like substantial further progress then that is the time to talk about tapering bond purchases;

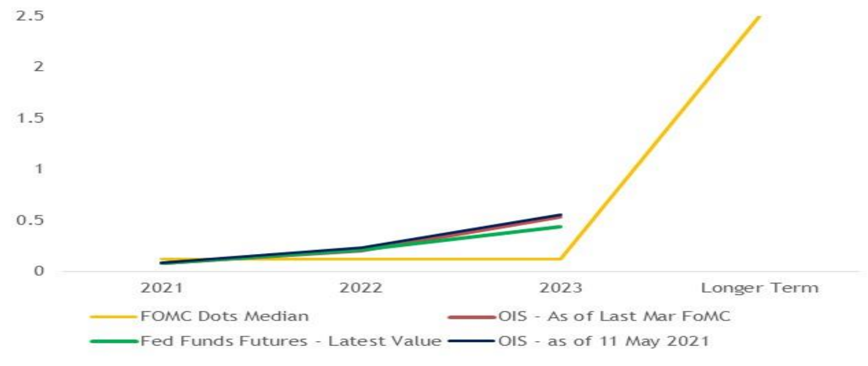
- In Fed Chair Powell's speech at the IMF panel in Apr, he said that the US economic recovery remains incomplete and that many Americans who are out of work will struggle to find new jobs. He drew reference to a homeless encampment in Washington as a visible reminder that many Americans are struggling;

- Fed's Kashkari said (4 May) that the US is still somewhere between 8mio and 10mio jobs below pre-pandemic and that policymakers need to do everything they can to put people back to work quickly. Recall earlier (in Apr) at another event at the Economic Club of New York, he said he would not have a knee-jerk panic if inflation heats up to 4% and it is important to establish whether high inflation was due to temporary factors or something that was more long-lasting. He also believes there is a lot of slack in the economy and that real unemployment rate should be more like 9.1% rather than the 6% reported for Mar;

- Fed's Bostic commented (13 May) that the US economy is in a "transitional period" as it reopens from pandemic with inflation volatile and workers closely considering their options. He added that the next 4-5 months could see a lot of noise for both prices and pace at which workers return to a potentially changed jobs market;

- At the last FoMC (29 Apr), Fed Chair Powell reiterated the same dovish rhetoric, saying that "it was not yet time to discuss scaling back asset purchases and it will take some time before we see substantial further progress". He also noted that economic "recovery has been faster than expected but it remains uneven and far from complete" and the economy "is a long way from our goals". Inflation pick-up was also been dismissed as due to transitory factors;

Fed's Dots Plot Looking for Rates to Stay at Current Levels Through 2023



Source: Bloomberg, Maybank FX Research & Strategy

We opined that Fed may have managed to reassure markets that it will not jump the gun and to be behind the curve with regards to policy normalisation/ tapering of bond purchases. It is likely Fed's current policy stance will continue for a few months as policymakers further re-assess incoming economic data. We probably may get the first signal from the Fed on tapering of bond purchases or policy normalisation timeline, closer to Jackson Hole Symposium (typically held in late Aug) or Sep FoMC. As such the next few weeks to months may present a window for UST yields to ease further, alongside lower USD. This scenario could pan out if data coming onstream turns out to be "less hot" than expected while re-emphasis on Fed's dovish rhetoric is necessary to soothe out market uncertainties. We continue to monitor wage augmented inflation data and expectations over the next few months to assess its impact on Fed policy and markets.

Nonetheless, Inflation Risks Not To be Taken Lightly Of

One challenge for markets and EM FX is how inflation evolves (much faster pace of increase than expectations or more persistent upticks) and market expectation on Fed's monetary response. We have seen earlier this year towards the late part of 1Q how the uptick in inflation and the lack of Fed's assurance triggered a run-up in 10y UST yield to a high of around 1.75% (2nd half of Mar 2021) resulting in the sell-off in bonds and underperformance of some AXJs, including IDR, MYR and KRW. This **taper-tantrum like episode could replay itself if prices continue to tick higher and other activity and employment indicators show up more strongly and earlier than expected** – a risk that should not be written off. In particular we note the recent uptick in US wages as a risk to watch.

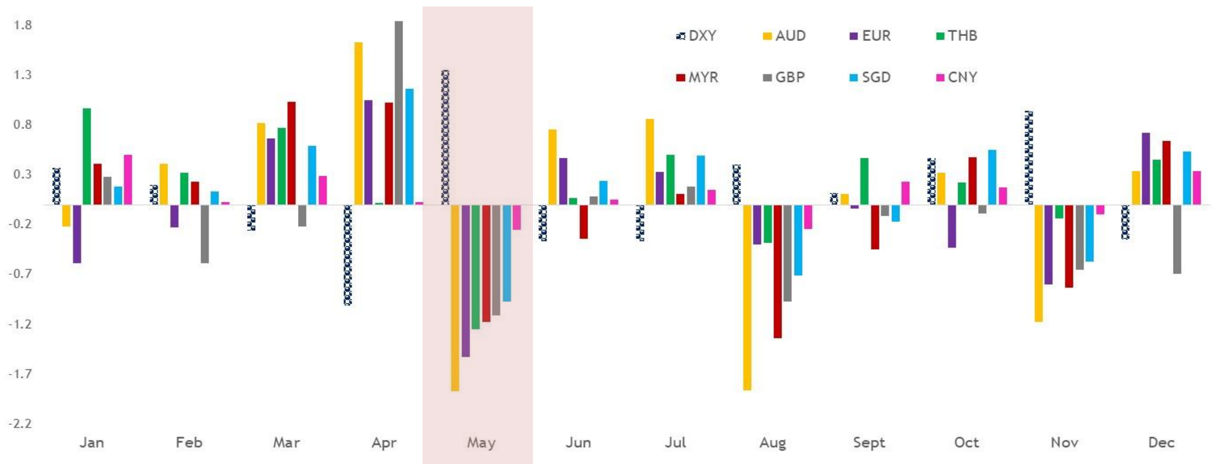
Ideally, a **sweet spot would be for incoming data - CPI, retail sales, inflation, labour to be "less hot"** – as this can setup a goldilocks scenario for risk assets including risk-proxy FX.

Concluding Remarks – Still Bias for Moderate USD Softness

Market moves are likely to be anchored on actual inflation data, market expectations of inflation and whether market buys the Fed's dovish messaging story.

For now, Fed's dovish rhetoric to remain behind the curve with regards to policy normalisation/ tapering may present a window for UST yields to ease further, alongside lower USD for the coming weeks to months (up to perhaps Jackson Hole Symposium in Aug or FoMC in Sep). One risk to this is "hotter" than expected CPI, activity or labor data as markets may not give the Fed the benefit of doubt. Another risk to highlight is USD seasonality trend in May as USD is typically strongest in the month of May, rising in 11 out of 15 months of May since 2005 with AUD, EUR, MYR, SGD and THB exhibiting the most weakness.

<u>**Near Term USD Upside Risks Due to Seasonality Trends in May**</u>



Source: Bloomberg, Maybank FX Research & Strategy

Beyond near term and over the course of 2021, broader market thematic of reflation, commodity rebound, vaccine trade remains in play, notwithstanding intermittent profit-taking (do not expect one-way trade for FX). More countries have rolled out vaccines and epidemic curves globally are showing signs of slowdown. Recent data such as PMI readings support the view that the global economy should continue to shed Covid-induced drags. Further gains in pro-cyclical FX (AUD, NZD, KRW, SGD) and commodity-linked FX (AUD, NZD and CAD) is expected. Barring new unexpected negative risk triggers, the path of least resistance for these FX should still be skewed to the upside over time. Countercyclical FX such as USD is likely to stay on the back foot.

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