

FX Insight

The Domino Impact of An Oil Shock

Double Whammy to Markets from Covid and Oil Shocks

Global FX are off to a volatile start this week. **Arguably, the oil shock was the “domino” that compounded Covid uncertainties and led to a flare-up in volatilities across various asset classes.** In this piece, we attempt to cover four key pieces to the current market puzzle: (i) State of markets now, (ii) Sensitivities of FX pairs to oil moves, (iii) How this current oil rout is similar/different to the 2014 experience, and (iv) What’s possible next? We end off with our current FX biases.

Billion Dollar Question in Oil Markets

The billion dollar question now is whether the negative macro impact of the OPEC+ break-up will bring Saudi and Russia back to the negotiation tables at the OPEC+ Joint Technical Committee meeting on 18 Mar.

- If Saudi tactics harden Russia’s stance and Russia also ramps up supply starting Apr, we do not rule out the risk of an aggressive price war (for market share) leading oil prices towards US\$25, with cascading effects on equities and commodity-linked and AXJ FX.
- Even if some signs of reconciliation between both parties emerge, cracks in the OPEC+ alliance could still dampen sentiments. We could see oil below US\$40 in the interim, especially if Covid contagion globally continues to dampen demand even as China recovers. AXJs (excluding MYR) may find a temporary breather—sensitivity analysis reveals some modest gains from oil price declines.

Revision to USDMYR and USDIDR Forecasts

Even as caution remains warranted as COVID-19 situation and Russia-Saudi tensions remain fluid, downward pressures on oil price seems likely. Utilizing estimated sensitivity parameters, we shift USDMYR forecasts to 4.22 (4.15 prior) in 2Q and 4.18 (4.12 prior) by year-end. For USDIDR, the double whammy (Covid, oil) to global sentiments has led to partial unwinding of the IDR carry trade. While we’re still cautiously optimistic on IDR once global sentiments turn—on resilient fundamentals, supportive BI, fiscal policy, renewed interest in higher-yielding IDR bonds—we revise end-2020 forecast to 13,700 (13,400 prior).

Relative Value Plays Preferred Stripping the USD Out

Given the current environment of oil price declines, equity sell-off, rally in bond prices and sharp spikes in volatilities, we would prefer AxJ FX that have lower sensitivity to market developments including oil, equities, lower risk of COVID-19 contagion. Some of these resilient AXJs include THB, PHP, CNH, TWD and SGD while on the other side of the vulnerability spectrum lies IDR, MYR and KRW.

In the G7 world, we do not prefer FX that are highly sensitive as well as those where their respective central banks have more room to ease or have contemplated unconventional monetary policies. Some of these FX include CAD, AUD and to some extent, NZD whereas typical safe haven FX, whereby their rates are already in negative territories and are perceived to have limited room for monetary stimulus - EUR and JPY - are favored.

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Currencies Off to a Volatile Start

Global FX are off to a volatile start to the week. Main trigger over the weekend was Saudi Arabia's decision to simultaneously offer deep discounts to oil buyers (in some cases slashing official prices by \$6-8 a barrel) and widen production (anecdotally Apr production may rise to between 10 and 11mn bpd, from about 9.7mn bpd this month).

These developments were likely in reaction to the decision by Russia on Friday. Russia had notified their OPEC partners that they were unwilling to cut oil production further, at a time when OPEC was aiming for supply cuts to mitigate damage to oil demand from Covid-19.

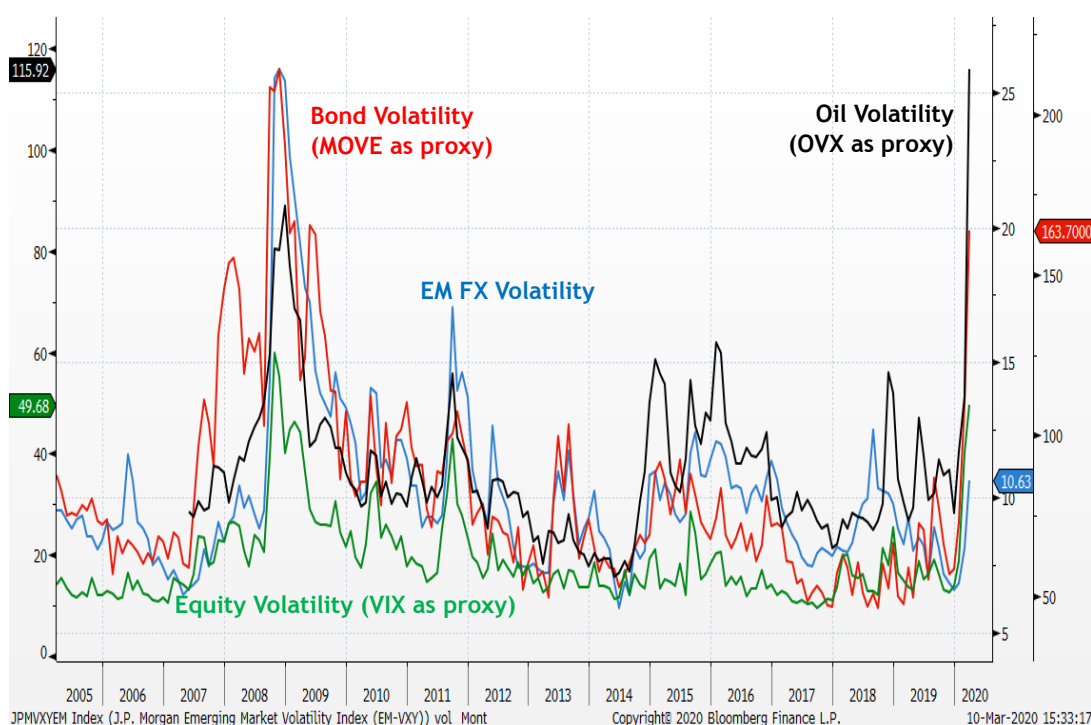
The proposal Russia had rejected was for an additional daily production cut of 1.5mn bpd overall (1.0mn bpd by OPEC and 0.5mn bpd by non-OPEC). Reports indicate that Russia's decision might in turn have been due to discontent over US shale producers benefitting from OPEC+ efforts to support oil prices.

In this piece, we aim to show **four key pieces** to the current market puzzle:

- State of markets now, including extent of volatility
- Sensitivities of FX pairs to oil moves
- How this current oil rout is similar/different to the 2014 experience
- What's possible next?

State of Markets - Panic like 2008-09?

Sharp Spikes in Vols - A Perfect Storm in the Making?

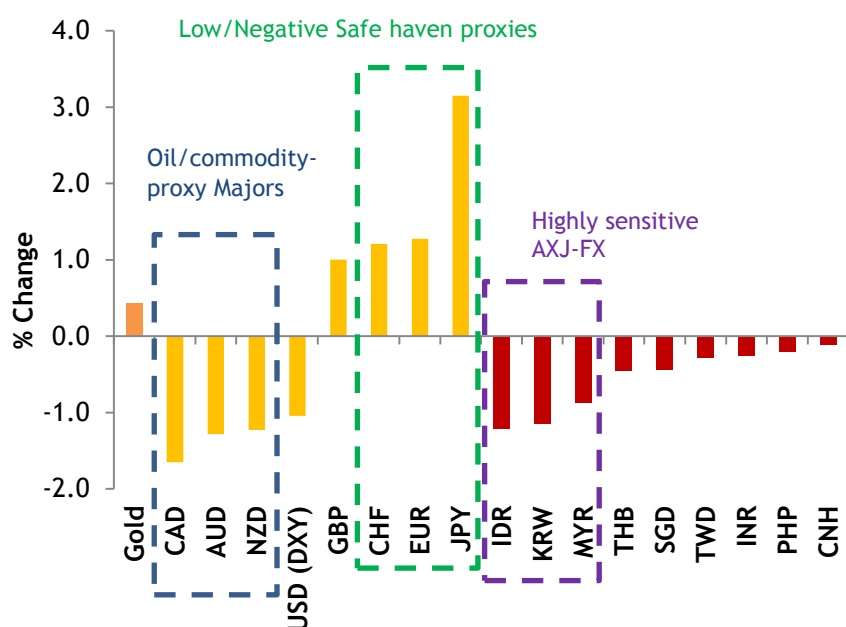


Source: Bloomberg, Maybank FX Research & Strategy

Volatility across asset classes in equity (VIX as proxy), bond (MOVE index as proxy), EM FX (JPM EM FX proxy) and oil (OVX as proxy) has jumped. In the case of oil, volatility has surged to record highs of 115.92 on the OVX while VIX and MOVE have risen to 54 and 163 levels, respectively - very close to GFC 2008-09 levels.

EM FX vols responded but the magnitude of its spike still lags the fear seen in oil, equity and bond markets. We do not rule out EMFX vol playing catch up with other asset classes, and if this happens, high-beta FX including commodity-linked and AXJs could see room for further depreciation while safe haven FX proxies such as JPY appreciate. But at the same time we recognise that Asian central banks in particular are less tolerant of excessive one-sided moves. As such this implies that *leaning against the wind* activities may partially mitigate rapid pace of depreciation.

Differentiated FX outcomes (vs. USD) on “Black” Monday

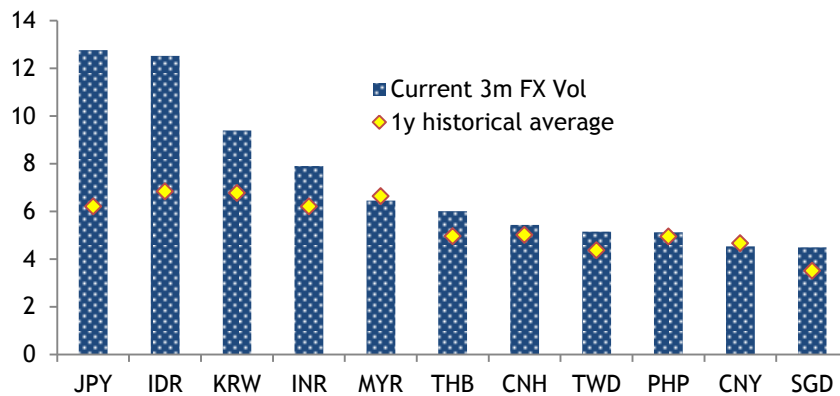


Source: Bloomberg, Maybank FX Research & Strategy Estimates

We see clear differentiation in outcomes between different G-7 currencies on Monday. Oil and commodity-linked currencies such as CAD, AUD and NZD are down, while haven assets such as CHF and JPY are in strong demand. Meanwhile, these developments have led to increased expectations of Fed rate cuts—Fed funds rates now indicate expectations for around for 3 rate cuts before or on the next Fed Meeting on 18 Mar—weighing on the USD and hence buttressing GBP and EUR outcomes vs. USD.

Meanwhile, most AxJ FX were in the red on Monday as well. Arguably, IDR and KRW were hit by the sharp shift towards global risk-off sentiments, reflecting the “domino” impact of elevated uncertainty regarding OPEC+ developments going forward. Oil-linked MYR was also down by around -0.9%.

Most AXJ volatilities Have Spiked - Worst for JPY, IDR, KRW



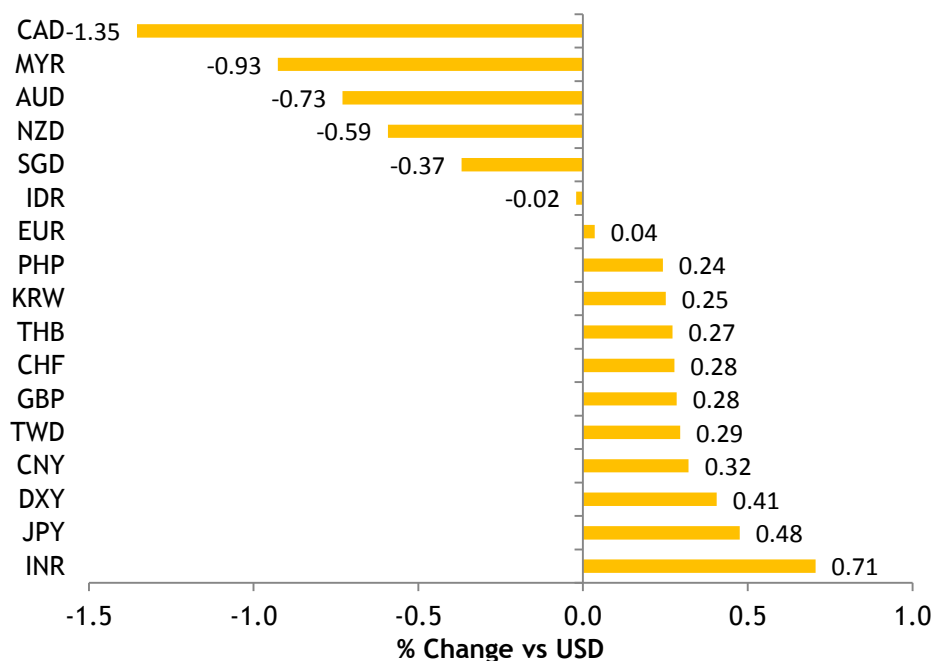
Source: Bloomberg, Maybank FX Research & Strategy

FX Sensitivities to Oil Moves

Amid current uncertainties, having a sense of how various FX reacts to volatile Brent price moves in the past might be useful as a reference still. We run a regression of currencies (in xxx-USD pairs) on Brent prices, controlling for equity performance (MSCI equities) and 10-year yield differentials between the country and USTs.

Sensitivities of various FX to oil price moves are extracted below.

Estimated FX Sensitivities to -10% Decline in Oil Price



Source: Bloomberg, CEIC, Maybank FX Research & Strategy Estimates

Note: Values used in regression are in log-form where applicable, and data from the past 5 years are utilized.

The results largely reinforce what we inherently know about FX dynamics. Net oil exporting countries could see revenues weakened and sentiments dampened from sharp drops in oil prices. Typical oil-linked FX proxies such as CAD is expected to be most hit, estimated to slip by around -1.4% for a -10% decline in oil prices. MYR could see softening by -0.9%.

While Australia and New Zealand are not huge net oil exporters, in broad commodity downturns, commodity-linked currencies are likely to see some negative impact as well.

For Singapore, given the open nature of its economy, and its unique use of the exchange rate as a monetary policy tool, sharply lower oil prices could feed in quickly to inflation expectations, and build up market expectations of MAS easing (i.e., weaker SGD).

Other currencies, including most other AxJ FX, could see modest upsides from lower oil prices, given lower oil import burden, with INR being the prime example. Nonetheless, structurally persistent lower inflationary pressures could then lead to bouts of monetary easing, which would potentially mitigate some of these (FX) benefits.

We note though that given the current interactive mix of market moving drivers (Covid, oil, fiscal and monetary reactions), the oil-specific elasticities above should be used with care. A particular concern is that it is still not fully clear at this point how this new oil dynamic will interact with current market disruptions from Covid, adding significantly to market uncertainty.

Comparison with 2014: Similarities and Differences

To arrive at some hints on the potential oil outlook going forward, we attempt to compare current developments with the oil rout in 2014.

Similarities:

- **Double Whammy in Demand & Supply Shocks:** In 2014, there were elements of supply (US shale, Canada's Alberta oil sands) and demand (slowing down of growth and oil demand in fast-growing China, Russia, India, Brazil) shocks. In 2020, IEA expects Covid impact to result in an annual drop of 90,000 bpd, the first decline since 2009 vs. potential large increase in supply from OPEC+ collapse. (-ve for Oil Outlook)
- **Saudi's Focus on Market Share:** Back in 2014, Saudi Arabia also opted to maintain market share via letting prices drop, given that its cost of production was lower than many other oil-producers. This time round, when Russia would not stomach further cuts, Saudi opted to gain first-mover advantage by firing the first discount salvos too. (-ve for Oil Outlook)

Differences:

- **Demand Shock - Transitory vs. Structural:** Arguably, even if Covid-19's contagion impact turns out to be more protracted than expected, recovery in oil demand would only be delayed (to 2021), but not completely derailed. The demand-side shock could still be viewed to be transitory overall, vs. structural shifts (decline in pace of growth in BRICs economies) seen in 2014. (+ve for Oil Outlook)
- **Speed of Market Moves:** Vs. the large >30% drop in Brent (at trough) on Monday, Brent took around half a year to drop by ~50%

in the second half of 2014 to sub-\$50 levels, and around another year to drop below \$30 per barrel. This reflects the unexpected nature of the OPEC+ break-up. Pending further signals from Saudi Arabia and Russia on whether the price war will materialize and how protracted it could be, prices could shift sharply from current levels. (neutral for Oil Outlook)

So What Now?

The billion dollar question now is whether the negative macro impact of the alliance break-up will bring Saudi Arabia and Russia back to the negotiation tables at the OPEC+ Joint Technical Committee meeting on 18 Mar or at least sometime soon.

- If Saudi tactics harden Russia's stance and Russia also ramps up supply starting Apr, oil could potentially see further downside pressure (possibly front-loaded in sentiments). We do not rule out the risk of an aggressive price war (for market share) leading oil prices towards US\$25. Russia's Finance Ministry said Monday that the country's \$150 billion National Wellbeing Fund could help the budget withstand 6-10 years of crude prices as low as \$25 per barrel. And this tension is expected to have cascading effects on equity markets (another sell-off) and commodity-linked and AXJ FX.
- Even if some signs of reconciliation between both parties emerge, cracks in the OPEC+ alliance could still dampen sentiments. We could see oil below US\$40 in the interim, especially if Covid contagion in other economies continues to dampen demand even as China recovers. AXJs may find a temporary breather from the sell-off on this but caution remains warranted as COVID-19 situation and Russia-Saudi tensions remain fluid.

While expectations are for shale production to be hit by low oil prices (with US shale-breakeven estimated to be around \$40-60 range), shale production might not see a sharp fall-off in the interim, on account of potential hedging in oil contracts and given that many shale producers are now owned by the oil majors (deeper pockets to withstand periods of low prices).

Revisions to Forecasts

Forecast	2Q 2020	3Q 2020	4Q 2020
USDMYR	4.22 (4.15)	4.18 (4.12)	4.18 (4.12)
USDIDR	14,000 (13,600)	13,800 (13,500)	13,700 (13,400)

Previous Forecast in Parenthesis

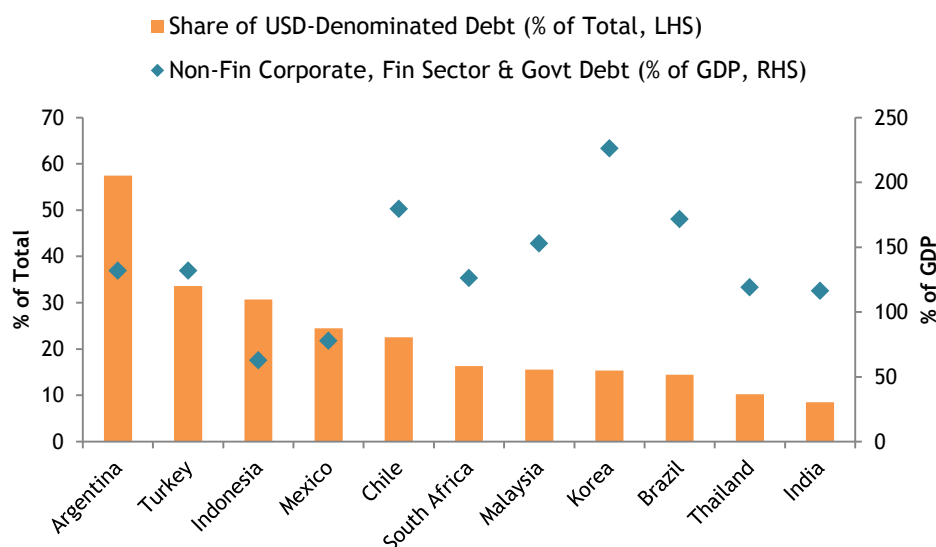
We revise our forecasts for USDMYR and USDIDR based on the latest developments. In a scenario where oil averages around US\$35-40 for 2Q and recovers modestly on reduced Covid drag to US\$40-45 in 2H 2020, MYR may see corresponding downward pressures in the interim. Utilizing

earlier estimated sensitivity parameters, we revise USDMYR upwards to 4.22 in 2Q and 4.18 in 2H.

For USDIDR, the revision upward is largely on its vulnerability to recent shifts in global risk sentiments on the unfortunate combination of global Covid contagion and OPEC+ shocks. In particular, pandemic fears have led to heightened risk aversion and volatilities across different market segments (refer to earlier volatility charts), leading to partial unwinding of the IDR carry trade. Cumulative outflows from Indonesian sovereign bonds have reached around -US\$2.3bn since the start of the year, partly a reflection of Indonesia's higher dependence of USD-denominated debt compared to peers (refer to Chart below). However, Indonesia despite producing crude oil is still a net oil importer and as such any further declines in oil prices on average could be positive for Indonesia. So the direct effects of the oil price move lower could lead to improved fiscal position due to reduced oil subsidies.

On net, we're still cautiously optimistic on IDR once global sentiments turn (on Covid recovery and more certainty in oil markets). Monetary and fiscal measures conducted by authorities (see our recent IDR piece [here](#)) and renewed interest in higher-yielding IDR bonds (once sufficiently cheap) could buttress outturns overall.

High Exposure to USD-Denominated Debt in Indonesia Poses Outflow Risks



Source: Institute of International Finance, Maybank FX Research & Strategy

Concluding Remarks on Non-USD FX

Given the fluidity and complexity of recent market events, we prefer to look at FX from 2 perspectives: (1) relative value excluding USD component and (2) our USD view.

Long THB, PHP, CNH, TWD, SGD vs. Short IDR, MYR, KRW

Given the current environment of oil price declines, equity sell-off, rally in bond prices and sharp spikes in volatilities, we would prefer AxJ FX that have lower sensitivity to market developments including oil,

equities, lower risk of COVID-19 contagion and some of these resilient AXJs include THB, PHP, CNH, TWD and SGD while on the other side of the vulnerability end lies IDR, MYR and KRW.

Long EUR, JPY vs. Short CAD, AUD, NZD

In the G7 world, we do not prefer FX that are highly sensitive as well as those where their respective central banks have room to ease or have contemplated unconventional monetary policies. Some of these FX include CAD, AUD and to some extent, NZD whereas typical safe haven FX whereby their rates are already in negative territories and are perceived to have limited room for monetary stimulus - EUR and JPY - are favoured.

Concluding Remarks on USD

Recent USD weakness (since 20 Feb) as a result of an erosion of dollar's carry and risk on status and Fed monetary easing provided a temporary breather for AXJs. In particular Fed's 50bps cut at the unscheduled but somewhat expected inter-meeting (3 Mar) to bring Fed fund target range to 1% - 1.25% demonstrated policymakers' commitment to act decisively when needed.

Markets are now pricing in 99% probability of 75bps cut at the upcoming FoMC (18-19 Mar) especially after the recent oil price massive sell-off amid Saudi-Russia stand-off on output decision.

Softer oil prices feed in to falling inflation expectations and that leads to expectations for easier monetary policies (rate for low, for longer). Also not forgetting rising likelihood of a deeper than anticipated economic slowdown amid COVID-19 outbreak, oil price decline repercussions on corporate survivability, investor confidence, economic growth, etc.

While USD's carry appeal has nearly eroded, its risk-on proxy appeal has also succumbed to a sell-off in US equities. Looking on, USD decline vs. safe haven/negative yielders such as JPY could continue but we warned that the USD decline will slow at some stage when UST yields have fallen low enough for USD to regain its safe haven status.

It remains prudent to stay cautious as COVID-19 situation remains fluid and contagion appears un-arrested in some parts of the world including Italy and S. Korea. Markets may run out of patience if COVID-19 takes longer to go away and the subsequent spill over effect on broad sentiment, manifesting itself on deeper sell-off in equities, HY credit and subsequently softer macro data in coming months will mean that AXJs gains will still be leashed even with a softer USD as negative sentiment can offset USD softness effect.

Refer to chart below for DXY technical analysis.

DXY - Rebound Not Ruled Out in the Interim

DXY has fallen by more than 5% since 20 Feb. Last seen at 95.75 levels. Bearish momentum on daily chart remains intact but RSI shows signs of turning from oversold conditions. We do not rule out rebound play in the interim.

Resistance at 96.35, 96.50 levels. Look for opportunities to lean against strength. Immediate support levels at 95.45 (38.2% fibo retracement of 2018 low to 2020 high) needs to break for more losses towards 94.10 (50% fibo) to gather traction.

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