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Global

FX Insight

Risks To Be Mindful Of

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Fastest Recovery on Record

We examine the current episode of equity recovery and note that the pace of rebound is well above that of the average of the past 10 bear markets since 1930s. At this point, we are cautiously optimistic on a broad perspective—on the back of policy stimulus, progress in vaccine development and a lower bar for upside surprises in economic data—but acknowledge that a multitude of risk factors can threaten to derail the recovery. We proceed to scrutinize two of these in detail.

US-China Tensions: Bark Worse than Bite?

With regards to finger-pointing on virus origins and Trump tariff threats, we outline reasons for why US' bark may be worse than its bite at this point, with fragile domestic consumption in particular limiting further tariff penalties that can be considered. We also note that underlying conditions (growth convergence, aggressive Fed easing) could mean that the blow to APAC-ex JPY currencies vs. USD may not be as large as before even if tensions rise again.

EM Fiscal Vulnerabilities

A comprehensive look at specific debt and reserve metrics among selected EMs suggests that potential drags to sentiments are more significant for non-Asian (vs. Asian) EMs, especially South Africa and Turkey at this stage. EM Asia looks to be in a better position to weather Covid-led fiscal stresses in general, even as we continue to monitor Indonesia's higher reliance on external funding with care. Nonetheless, we caution that a risk trigger coming from non-Asian EMs may still hurt sentiments and also EM Asian assets via broad portfolio re-allocations if losses hit in current environment.

Stick to Our FX Biases at this Point

On net, while the confluence of risk factors remains dynamic, we think that current developments have yet to derail our prior preference for tech-linked Asian FX such as TWD, KRW, as well as SGD. Resumption in underlying tech trends should be sustained in the months ahead still. However, we like to note KRW's sensitivity to trade tensions and EM vulnerabilities via the sentiment channel. As such, a strong manifestation of any of the risks could still overwhelm fundamentals for KRW.

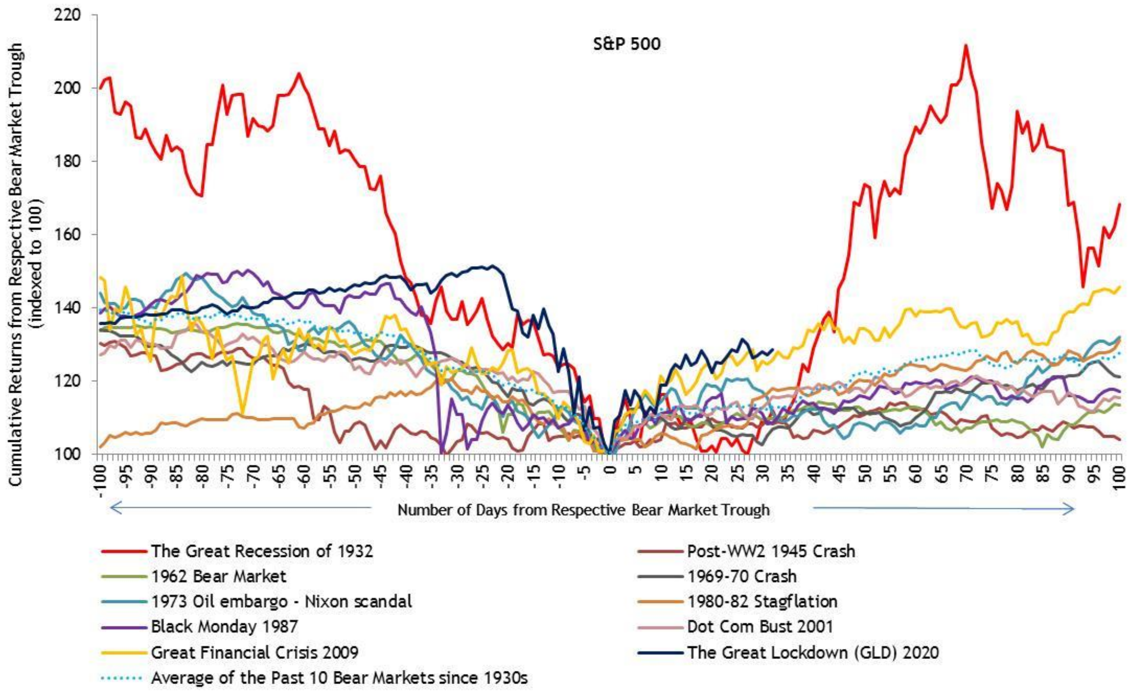
For IDR, we remain positive on a longer-term basis but risk-reward may not be optimal for long positions at this point. We continue to favor JPY longs as a hedge. Recent attempts at USDJPY rallies have quickly lost momentum and retraced lower, as markets increasingly demand protection against a myriad of risk factors.

Risk Sentiment - Have We Jumped the Gun?

As of 6 May, some equity markets, including S&P 500, KOSPI have rallied as much as above 30% while most others in Asia have risen between 15% and 30% since 23 Mar trough. And the rebound thus far is a reflection of markets finding comfort from powerful policy stimulus, COVID-19 pandemic showing signs of coming under control and some parts of the world gradually easing lockdown measures, though social distancing measures and travel restrictions remain a normalcy for now. Potential progress with drug remdesivir to treat covid-19 symptoms further lends support to risk-on sentiment.

But the question remains if the rally of this magnitude is justified especially when there are plenty of risks. To get a sense of the current market rebound, we look back at 10 bear market rebounds (of magnitude above 20%) over the last 90 years or so. For this exercise we use S&P500 index as a sentiment proxy for comparison and we made an assumption that the Mar 2020 low serves as a tentative trough for this Great Lockdown episode to allow for historical comparison. We said this is a tentative trough because there are still many downside risks, such as the risk of second wave infection, re-escalation of US-China trade disputes, oil shocks, etc. and some may argue that it may be premature at this stage to concur that Mar 2020 was indeed the low point for this episode.

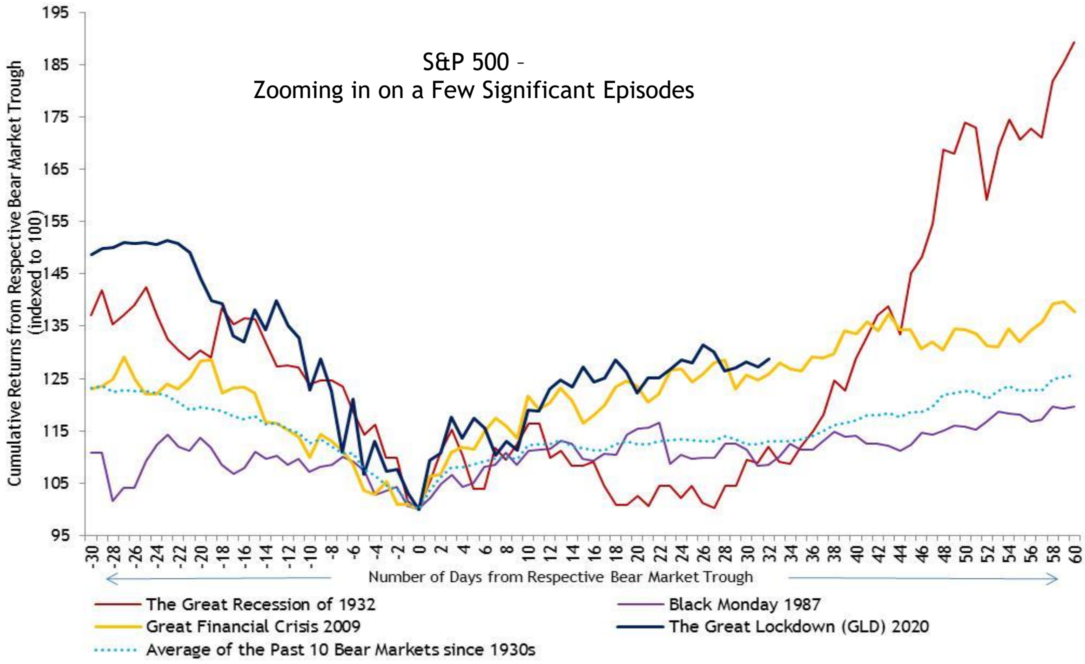
Current Episode of Rebound is By Far the Sharpest Historically



Source: Bloomberg, Maybank FX Research & Strategy

Some Findings: (1) a comparison against past bear market rebounds shows that the current episode (The Great Lockdown 2020) so far (30-days post rebound) is indeed the sharpest and fastest historically, with the pace of rebound well above that of the average of the past 10 bear markets since 1930s. (2) In terms of the durability and magnitude of the bear market rebound over a 70-day period, the rebound in the 1932 Great Recession far supersedes any rebound episode. (3) Most bear market rebounds retest its lows again about 60 -70% of the time before making another rebound.

Current Episode of Rebound Mirrors Post-GFC Rebound



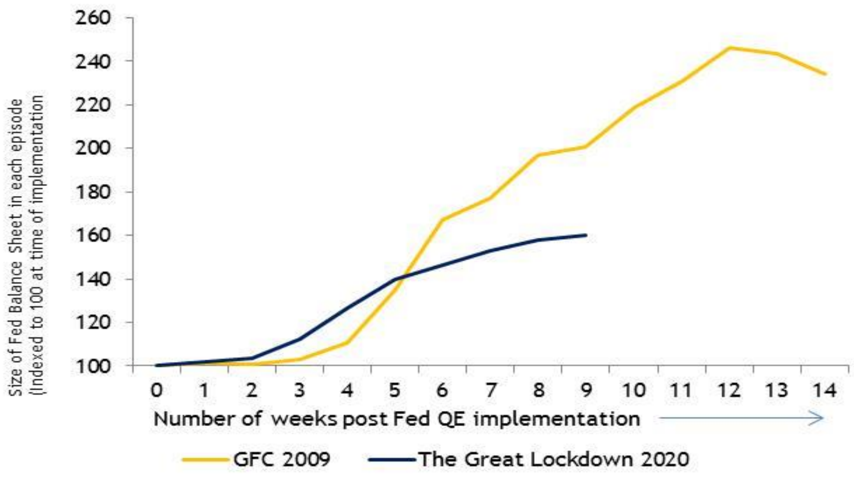
Source: Bloomberg, Maybank FX Research & Strategy

Similarities and Differences between GFC and GLD rebound

One notable observation is that the current rebound mirrors that of the GFC 2009 episode, in terms of trajectory and magnitude 32-days post rebound from respective trough. But we note that the triggers, market conditions and macro landscapes are somewhat different for the 2 episodes. During the GFC, the downturn of the US housing market was the trigger for a financial crisis contagion that started from US to the rest of the world via linkages in the global financial system. The current crisis was caused by COVID-19 becoming a global pandemic. Drastic but necessary actions to contain the spread of COVID-19 (via country lockdowns, travel restrictions and social distancing measures) severely impacted economic activities. IMF made one of its most bearish economic assessment - projecting global growth to be -3% for 2020, 6.3ppts downward adjustment from Jan-2020 forecast making the great lockdown the worst recession since the Great Depression and far worse than the Global Financial Crisis.

But to some extent, there are also slight similarities in both episodes. Massive monetary policy responses were very quickly put in place in 2008 and 2020. Fed’s deployment of substantial quantitative easing was instrumental in both episodes’ bear market rebound. And to some extent, one may be tempted to attribute massive and rapid QE policy response as one of the key reasons behind the similar rebound trajectory.

Pace of Fed QE in GFC vs The Great Lockdown 2020



Source: Bloomberg, Maybank FX Research & Strategy

The relative milder pace of increase in Fed stimulus this episode relative to GFC suggests that Fed could still do more if need be to alleviate funding market and liquidity stresses, or support the economy especially if some of the risks we identified materialised.

Divergence of Financial Markets from Economic Realities Not Sustainable

We believe the sentiment remains fragile as economic reality sets in over the coming weeks and months. Global capex spending is expected to be scaled back across most industries especially in the energy sector as demand falls while corporate fallout (i.e. pickup in corporate bankruptcies and rating downgrades) remain a big risk.

US is potentially looking at a huge spike in unemployment rate to 16% (from its recent 5-decade low of under 4%). US payrolls data will be in focus (8 May). Expectations for NFP to post 22mio job losses in Apr (up from -701k in Mar) while unemployment rate is expected to spike up to 16% (from 4.4% in Mar). A worse than expected payrolls data pose downward pressure on high beta FX proxy including AXJ, AUD and NZD while the USD could see support. For DXY, it may not be as clear given that other lower, negative yielders (safe haven proxy) such as JPY, CHF and to some extent EUR) makes up 75% of the DXY. If payrolls are a lot worse than expected, then market expectations for US rates to head deeper into negative territories will probably be more pronounced (vs. current of -0.02% seen in Dec contract of 30d Fed fund futures). This would narrow the UST vs other G3 yield differentials further, and as such the DXY may not ultimately outperform those negative-yielding majors on this front.

On a global scale, the International Labour Organisation (ILO) projected job losses of up to 305mio globally (up from earlier estimates of 195mio due to prolongation and extension of lockdown measures).

Consumer spending may recover but only slightly despite lockdown measures being gradually lifted as social distancing and travel restrictions are still in place amid fears of second wave covid infections.

Services PMIs across the world remains deeply in contractionary territories (low double digits) while consumer confidence indicators have yet to reflect any turnaround in pessimism.

The current state of economic realities suggest that conditions could get worse if we face further shocks (i.e. re-escalation in US-China trade tensions, second wave covid infection, EM stresses, oil negative surprises, etc.).

Grim Economic Reality but a Lower Bar for Upside Surprises

Services PMIs

Country / Region	Apr-2020	Mar-2020	Feb-2020	Jan-2020	Dec-2019	Nov-2019
China		43.0	26.5	51.8	52.5	53.5
Eurozone	12.0	26.4	52.6	52.5	52.8	51.9
Germany	16.2	31.7	52.5	54.2	52.9	51.7
India	5.4	49.3	57.5	55.5	53.3	52.7
Italy	10.8	17.4	52.1	51.4	51.1	50.4
Japan	22.8	33.8	46.8	51.0	49.4	50.3
United Kingdom	13.4	34.5	53.2	53.9	50.0	49.3
United States	26.7	39.8	49.4	53.4	52.8	51.6
World		37.0	47.1	52.7	52	51.6

Manufacturing PMIs

Country / Region	Apr-2020	Mar-2020	Feb-2020	Jan-2020	Dec-2019	Nov-2019
China	49.4	50.1	40.3	51.1	51.5	51.8
Eurozone	33.4	44.5	49.2	47.9	46.3	46.9
Germany	34.5	45.4	48.0	45.3	43.7	44.1
India	27.4	51.8	54.5	55.3	52.7	51.2
Indonesia	27.5	45.3	51.9	49.3	49.5	48.2
Italy	31.1	40.3	48.7	48.9	46.2	47.6
Japan	41.9	44.8	47.8	48.8	48.4	48.9
South Korea	41.6	44.2	48.7	49.8	50.1	49.4
Taiwan	42.2	50.4	49.9	51.8	50.8	49.8
United Kingdom	32.6	47.8	51.7	50.0	47.5	48.9
United States	36.1	48.5	50.7	51.9	52.4	52.6
World	39.8	47.3	47.1	50.3	50.1	50.3

Source: Market, Bloomberg, Maybank FX Research & Strategy

We reiterate our stand that we are not out of the woods as COVID-19 epidemic curve has yet to flatten meaningfully (and evenly) across the world; lockdowns, travel restrictions and social distancing measures are still in place (dampener on business activities, corporate survivability) and there is not yet any strong evidence of a medical breakthrough in terms of vaccine development. Risks of second wave infection, re-escalation of US-China trade disputes remain very real at hand.

And these will could weigh on sentiment and subject S&P 500 to a re-test of its Mar 2020 lows. In this scenario, pro-cyclical/ growth-linked AXJs including KRW, MYR could be at risk for bouts of depreciation pressures while haven proxy FX such as JPY remains a good hedge against caution.

However, that is not to say we see an everlasting gloom. In fact we are cautiously optimistic on a broad perspective. Policy stimulus measures are likely to remain in place for longer as policymakers have already stressed that they are willing to even do more if need be. This provides a backstop and safety net for markets. Moreover there are already nascent signs of progress on vaccine development. If a ready vaccine can come faster than expected (given technology advancement), market and business confidence can be rebuild and economic activities could return to normalcy. Record low PMIs, though an indication of a worrying state of economic growth for now but on the contrary it also suggests that the bar for upside surprise is lower. Improvement in PMIs as economies re-open could instead lend support to sentiment.

For the rest of this report, we proceed to examine two key risk factors that are gaining prominence in market chatter, i.e., (i) re-emergence of tensions between US and China, and (ii) EM fiscal vulnerabilities exacerbated by Covid-led drag. Broadly, we find that downside risks to EM Asia FX from these factors are largely contained at this point.

Key Risk 1: Can the US Withstand Another Trade War with China?

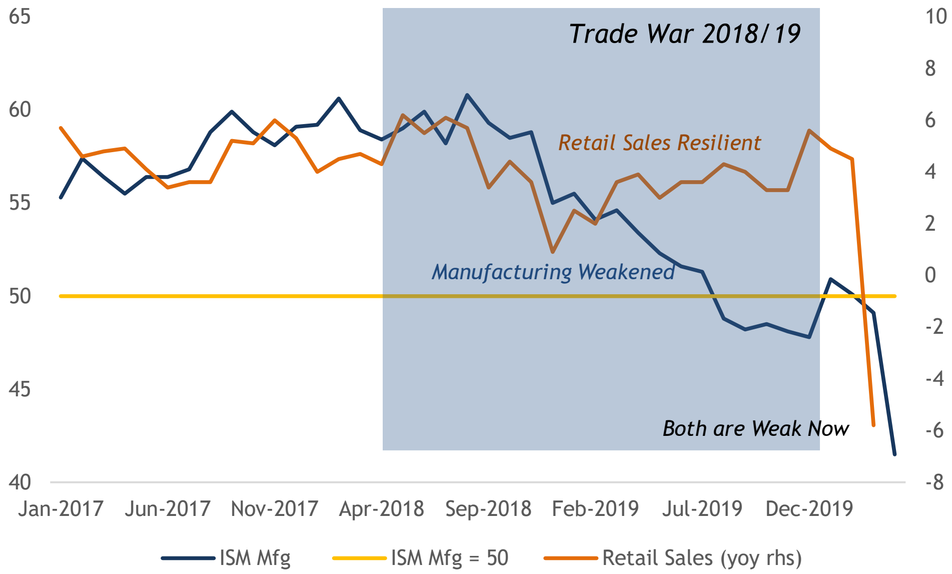
A supposed 15-page dossier, documented by Five-Eyes intelligence alliance was leaked to The Saturday Telegraph. The paper suggests that China had lied about human-to-human transmission of the virus, eradicate evidence of it in laboratories, refuse to provide live samples to aid foreign scientists' efforts on a vaccine and allowed millions of people to leave Wuhan after the outbreak before the lockdown on 23 Jan. *(The Five Eyes is an intelligence alliance that comprise of Australia, Canada, New Zealand, the United Kingdom and the United States.)*

Armed with evidence that the COVID-19 came from a laboratory in Wuhan (likely to be based on the leaked research paper), Trump threatened to impose more tariffs on China as "the ultimate punishment" and said that the deal would be off if China does not keep up with its purchases.

But, Can He?

Trump launched the trade war with China in 2018 when jobless rate in the US has just slipped under the 4.0%-level (around a two-decade low) and growth was being bolstered to full steam by tax reforms. The tariffs then mainly targeted intermediate goods and thus, the impact was felt more acutely in the manufacturing sector while the US consumer remained a pillar of the economy.

US Manufacturing Was Hurt by Trade War but Consumption was Resilient



Source: US Census Bureau, Bloomberg, Maybank FX Research & Strategy

With manufacturing already weakened by the earlier phases of trade war, ISM Mfg shows manufacturing is now in deep contraction from COVID-19. The environment is now vastly different as the global economy was severely hurt by Covid-19. Most of the tariffs scrapped in 4Q 2019 would have affected consumer and capital goods. It is thus difficult to imagine how the Trump administration would inflict more pain on the economy at a time where the US has already witnessed a massive scale of layoffs (>20mn) amid the shutdowns of non-essential businesses across the country. Concerns about current and future income sank consumer sentiment. The University of Michigan final sentiment index for Apr slumped 17.3 to 2011-low of 71.8. A tariff action on Chinese imports of consumer and capital goods could worsen the already weak household spending and capex.

Most Likely Scenario of All Bark and No Bite

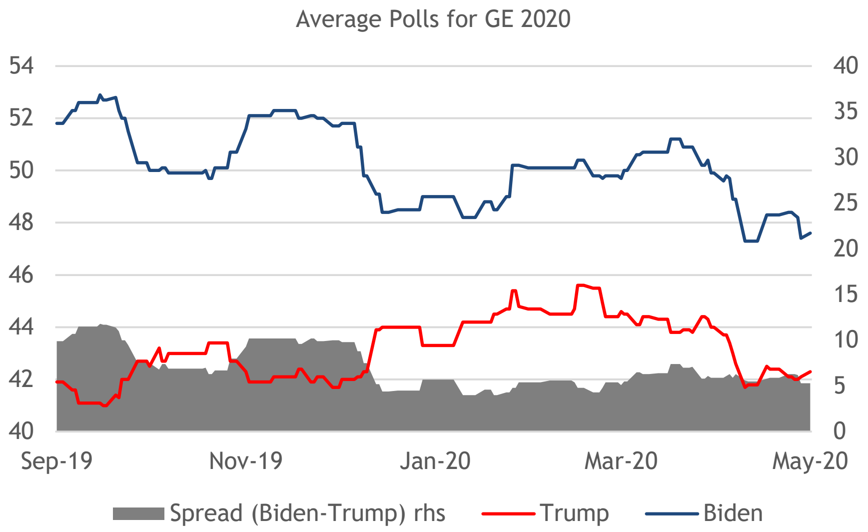
From the economic perspective, it is thus hard to be convinced that Trump would go ahead with more tariffs on China – the major economy that is ahead of the rest of the world in terms of Covid-19 normalization. China's recovery may also boost the recovery of other countries as more start to jumpstart their economies from variants of shutdown/lockdowns. A curtailment of its recovery would also affect the pace of recovery in other parts of the world and we are still in a fragile phase of re-opening where coordination rather than conflict is more constructive in virus containment. So his recent threats of more tariffs could be a result of simply political pressure.

Trump had a few tweets around the time of fresh tariff threats.

"Fake Polling, just like 2016 (but worse!)" – 30 Apr 2020.

He seems to be referring to the polls statistics tabulated by *Real Clear Politics* on the General Election that showed a 5.3 point advantage that presumptive Democratic Presidential Nominee Joe Biden have over him.

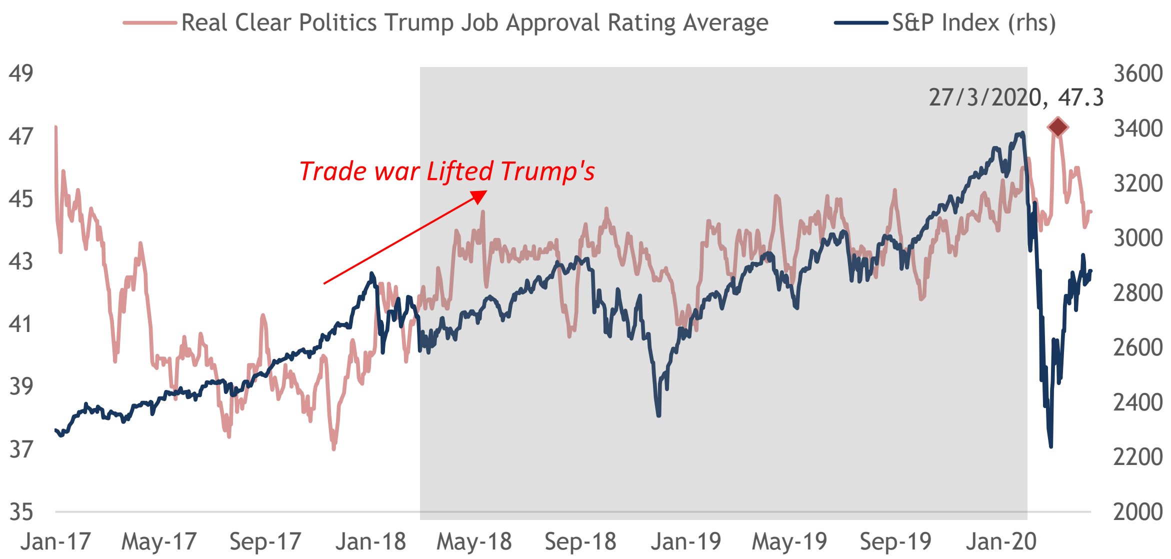
Joe Biden Has A Higher Poll Rating for GE2020



Source: Real Clear Politics, Bloomberg, Maybank FX Research & Strategy

Trump's job approval rating had also slipped from its Mar highs as death tolls from Covid-19 rose at home. Poll results typically vary as the recent release by Gallup showed a surge in the approval ratings for Trump, which was a sharp rebound to 49% vs the dismal print of 43.0 in the previous release (a fortnight ago). He reacted to the Gallup poll with a triumphant tweet too.

Trump's Trade War Lifted his Ratings in 2018



Source: Real Clear Politics, Bloomberg, Maybank FX Research & Strategy

Note: Real Clear Politics Job Approval Rating is an average of poll results from Reuters/Ipsos, Economist/YouGov, Rasmussen Reports, Politico/Morning Consult, CNBC, Monmouth, IBD/TIPP, Emerson with latest polls conducted over 26 Apr - 6 May.

Regardless of the swings of the approval ratings and where it sits at this point, **Trump had benefitted from a trade war that he launched which kept his job approval ratings rather steady for 2018-2019 as shown in the chart above.** His approval rating had fallen for much of 2017 into 2018 before the trade war with China lifted his ratings alongside factors such as the tax reforms then. As we write in May, around six months ahead of the US Presidential General Election 2020, he may continue to harp on tariffs as a way to lay blame on China as the culprit that brought COVID-19 to the US in order to shore up political support ahead of the election but severe economic data could keep him from following through unlike 2018-19.

China Reacts with Calm So Far

Since the leak of the Five Eyes' Dossier (which UK Defence Secretary recently refused to comment on), WHO had stepped out to assure that the virus is likely organic. China also said that the accusations by the US officials of hoarding medical supplies were "groundless". Insofar, there has not been much direct response to Trump's tariff threat.

The one indicator that everyone watched for was the USDCNY reference rate. The fix can be taken as a sign of response from China, after a long break. The reference rate on Wed (6 May) was well within expectations at 7.0690. Taking reference from the 2018/19, the USDCNY fix can be seen as an indicator of calm and an anchor for sentiments. In addition, China has already scheduled the yearly National People's Congress to be held on 22 May. It is also unlikely that PBoC would allow for excessive weakness in the RMB around the event.

With China reacting with calm and Trump being checked by severe economic reality, it is more likely that this could be a **case of all bark and little bite.** However, Trump's determination to fault China for its lack of transparency could still mean further deterioration in US-China relations. The risk of further tariffs could still keep the USDCNH supported on dips as long as Trump continues to keep the threat coming.

Alternative Scenario

In the less likely scenario that Trump decides to act and "punish China". There are a few tools that he can use. He had himself said that tariffs would be the "ultimate punishment" for China. So that makes tariff the likeliest tool of choice. We thus revisit where Trump and Xi had left off in Jan this year to have a sense of what he may do by using the 2019 trade war script.

The making of the US-China Trade Deal phase 1 took a few months. Within those few months (around Oct 2019 –Jan 2020),

1) the scheduled tariff increase on $250bn of Chinese imports from 25% to 30% that was supposed to take effect on 15 Oct 2019 was cancelled;

2) the plan to impose another 15% on $160bn of Chinese imports on 15th Dec 2019 was also delayed. That was later scrapped on 15th Jan when the phase 1 of the US-china trade deal was inked.

3) Part of the pact also provided for the US to half the tariffs from 15% to 7.5% on an estimated $112bn of Chinese imports that took effect on 1st Sep 2019.

So, based on what was worked on before, Trump could reinstate these three tariff actions that were either scrapped or unwound when the two nations started to work on the deal in the 4Q of 2019.

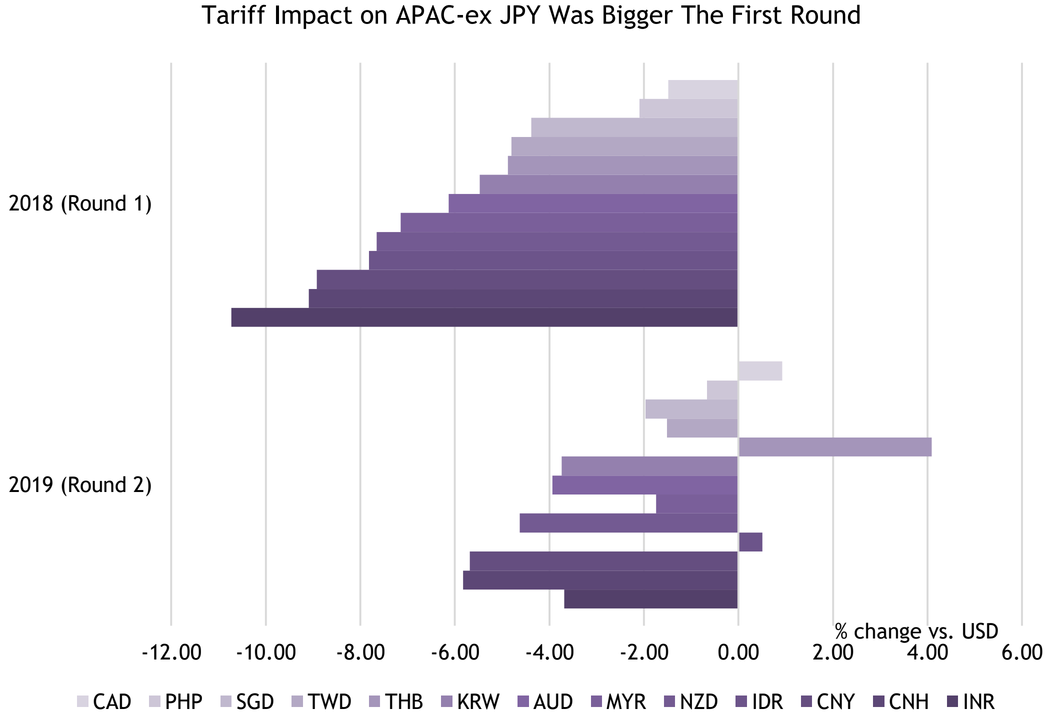
Apart from the US tariffs, Trump administration had considered limiting US investors' portfolio flows into China as a retaliatory action last year. There could have been some moral suasion done via Trump's tweet asking US firms to exit China but Trump does not have the power to direct commercial activities. Fast forward to 2020, given the COVID-19 pandemic and National Emergency Act invoked, Trump may be able to tap on the International Emergency Economic Powers Act of 1977 which "authorizes the president to declare the existence of an 'unusual and extraordinary threat… to the national security, foreign policy, or economy of the United States" that originates "in whole or substantial part outside the United States". "Any exercise of such authorities to deal with any new threat shall be based on a new declaration of national emergency which must be with respect to such threat." Trump has to consult with the Congress (albeit without need for approval) before exercising any of the authorities granted by the Act to block transactions and freeze assets.

This could potentially enable the US to renege on its interest payments to China for its UST holdings without being recognized as a default. We see this as highly unlikely. Even as the rating agencies do not deem the stop-payment as a default, the UST yields could still spike, increasing the debt burden of the Treasury at a time where financing is badly needed to manage the pandemic situation. In addition, China may also start to reduce holdings of US debt which is another threat to the US and the rest of global markets. As such, we think that these tools are less likely to be tapped on.

In any scenario that Trump acts and strains the US-China relation further, it is likely that CNY would be weakened, similar to previous episodes of trade war in 2018 and then in 2019. However, we note that second round of tariffs in 2019 saw smaller reactions in the non-USD FX vs. 2018.

We split the trade war of 2018-2019 into two rounds, noting the more amicable phase in between when both nations announced a tariff truce on 1st Dec at the G-20 meeting in Buenos Aires.

Non-USD FX was less hurt in the Second Round of Tariffs in 2019

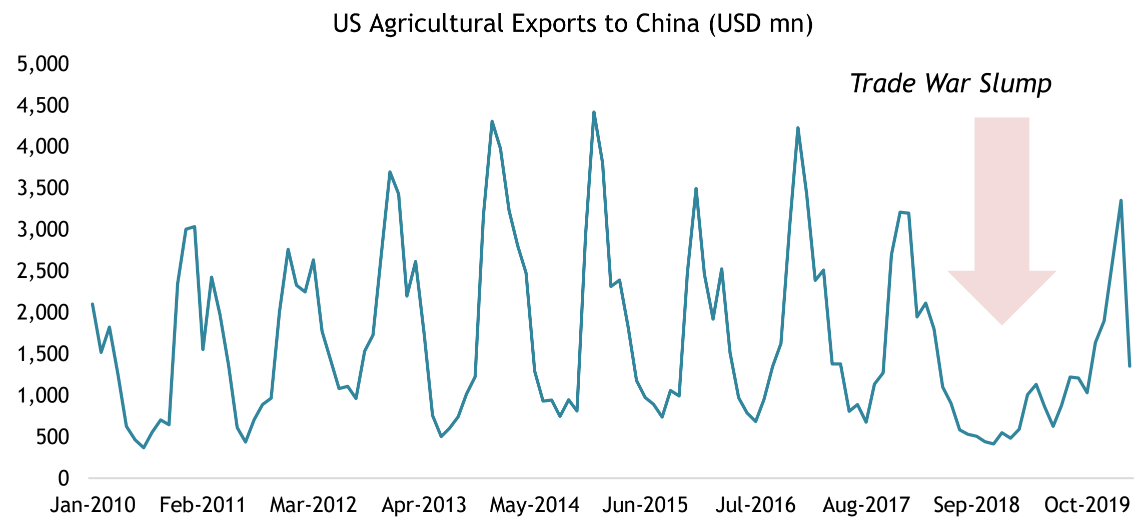


Source: Bloomberg, Maybank FX Research & Strategy
Note: Round 1 takes the currency performances between Apr-Nov 2018 (roughly the trough and peak of USDCNY). The start of the period also coincides with Trump's first tariff threat on 3rd Apr 2018. Round 2 takes the currency performances between 4 May – 2 Sep 2019. The start of round 2 coincides with Trumps renewal of tariff threats.

Based on the currency performances in the two rounds, the impact on currencies in the second round was less severe. This could be due to a few factors including the USD strength which was more pronounced in 2018 vs. 2019. The Fed was also on a hiking cycle in 2018 but soon shifted to an easing cycle in 2019. The USD and rates environment were thus both more supportive of regional currencies in 2019 relative to 2018. The third factor could be that the second tranche of tariff was basically smaller in magnitude vs. the first. Hence, the impact on FX was also correspondingly lower.

2020 is marred by COVID-19. Another impact on growth brought about by tariff actions could be negative for regional currencies. However, just as the chart has shown, the subsequent rounds of tariffs could have diminishing marginal returns on its blow to non-USD currencies. This is especially due to the fact that the US is no longer on a divergent course (Strengthening) vs. Rest of the World (Weaker) as seen in 2018-2019. Carry advantage that the USD commanded then, is now wiped out by the Fed's aggressive rate cuts and QE. It is also challenging for the Trump administration to impose significant tariffs vs. what was seen in the last two years and the tariffs themselves would have rippling effect on the already weakened US economy. This does not mean to say that the USDAxJ currencies would not be affected or would even fall due to the above factors. The USD remains a dominant currency of choice for modes of payment. Its safe haven, funding/liquidity characteristics would mean intermittent support in times of stress. However, the abovementioned factors suggest that APAC-ex JPY currencies may not weaken as much as before.

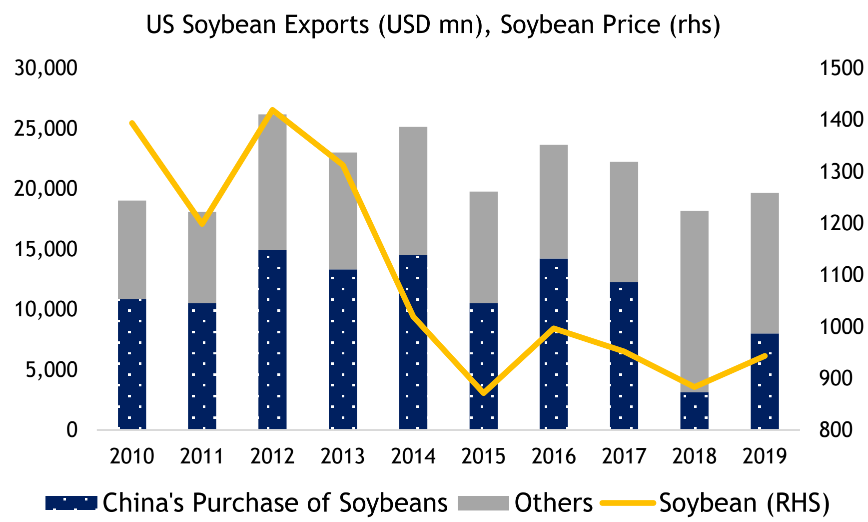
China's Retaliations in the Past had Usually been In Kind



Source: China General Administration of Customs, CEIC, Maybank FX Research & Strategy
Note: Agricultural exports is the sum of exports subcomponent of Live Animal; Animal Product, prepared foodstuff and vegetable product to the US.

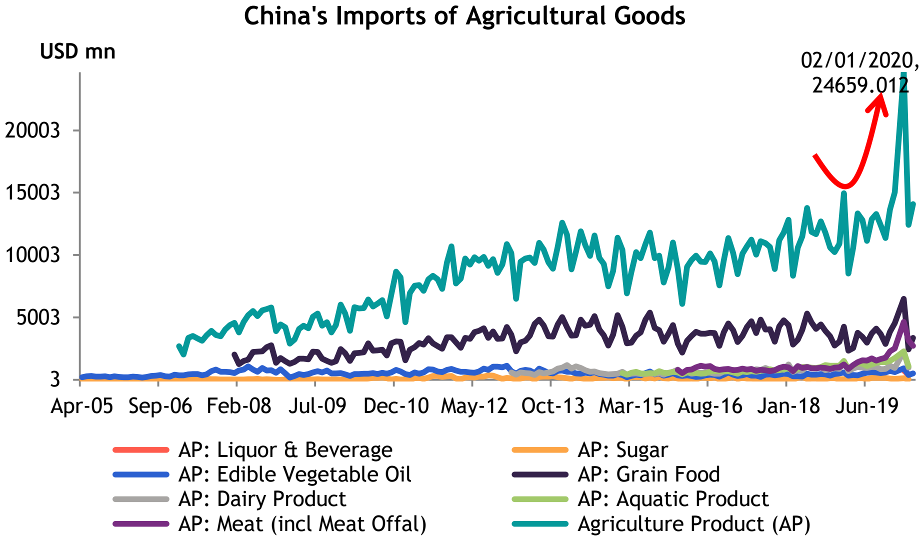
Another key sector that was hurt significantly was US agriculture and that was due to the retaliatory action of China. During the years of 2018-2019, China did not buy much of US agriculture. Soybean was a focus and the absence of China's order depressed prices. China could certainly stop buying agriculture goods again in order to hit Trump where it hurts most – his political base. So this is another negative repercussion of further tariffs that would hurt Trump's bid for a re-election.

China Stopped Purchasing Soybeans in 2018 and Prices Fell



Source: US Census Bureau, Bloomberg, Maybank FX Research & Strategy

China Has Been Purchasing More Agricultural Goods This Year, Especially Grains



Source: Gen. Admin. of Customs (China), CEIC, Maybank FX Research & Strategy

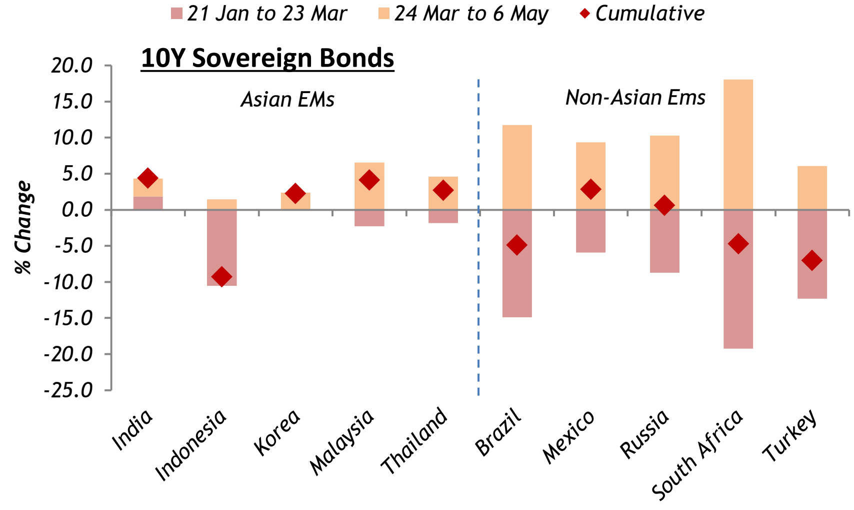
Update: On 6 May, the Trump assured that he would know in a week's time whether China has kept its end of the bargain. Soon after, sources cited by SCMP reported that a call is scheduled for USTR Lighthizer and China Vice Premier Liu He to discuss the implementation of phase 1 of the trade deal signed on 15 Jan. A statement released by China's Ministry of Commerce declared that a call has already been made between the two leaders this morning (8th May) and "agreed to strengthen their cooperation with regards to the economy and public health. They will work towards building a constructive environment to implement the terms of the phase 1 of US-China trade deal. Both sides have agreed to maintain communications". While there were no details revealed and the dialogue is still likely to be at an early stage, a dialogue should still be taken positively. The deal has stated a call for review every half yearly so this call could be a little earlier than scheduled. Ahead of the report, agricultural imports of China (reported on 7 May for Apr) was ramped up so far in 2020.

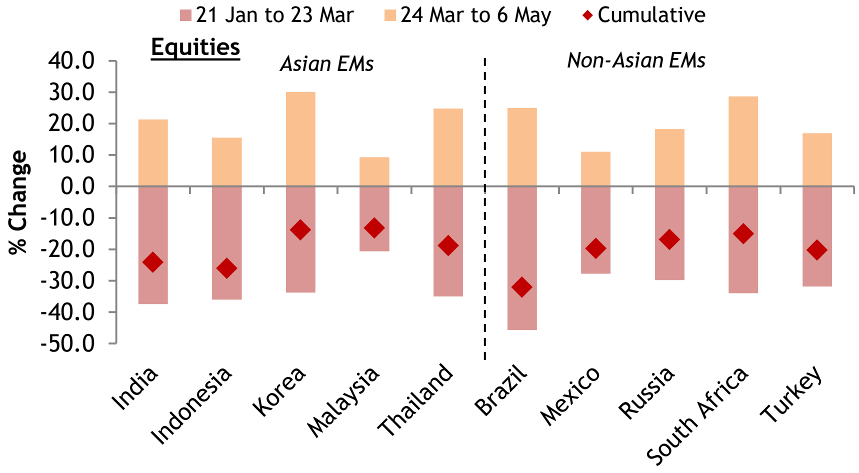
Key Risk 2: EM Vulnerabilities Scrutinized

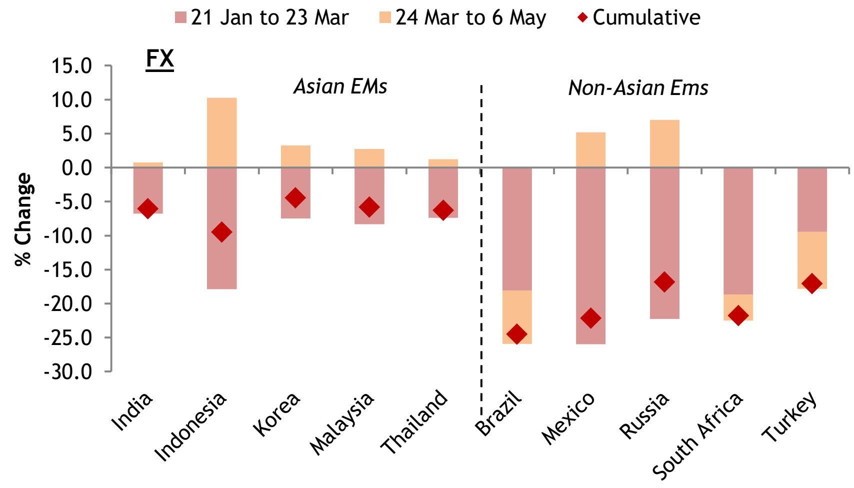
EM risks have become a concern for some market participants amid concerns that Covid-led macro drags on economic activity, jobs, tax revenue collections etc. could exacerbate existing stresses in funding needs among EMs, especially if these needs are externally sourced.

Looking at the performance of high yield sovereign bonds, equities and currencies of selected EMs, we assess that these concerns likely peaked in late March, and eased a tad in April. Volatility in sovereign bonds and FX were also notably higher for non-Asian EMs vs. Asian EMs.

Sell-offs in EM Assets Likely Peaked in Late-March

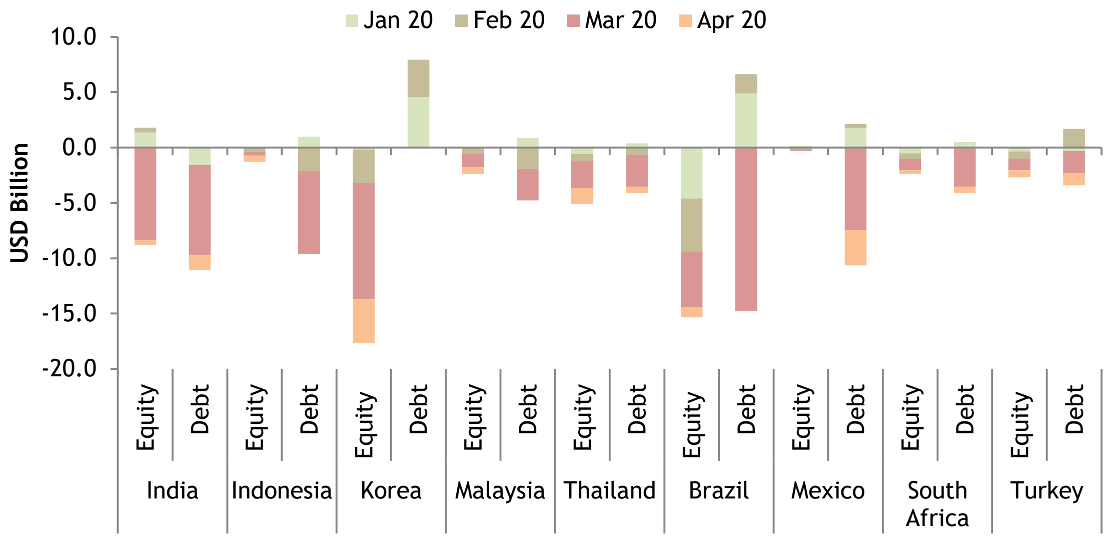






Source: Bloomberg, Maybank FX Research & Strategy

Portfolio Outflows Eased In April But Markets Remained Cautious



Source: IIF, Maybank FX Research & Strategy

Note: April 2020 data for Malaysia debt, Brazil debt and Mexico equity flows are not available yet. Latest data point for Korean debt is as at Feb.

Congruent with the performances of the asset classes, we note that EM securities experienced US$83.3bn in outflows during March, significantly larger than outflows seen during the 2008 financial crisis or the 2013-14 taper tantrum event. This severe drag then presumably eased in April, as seen in the chart above. Nonetheless, EM ex-China equities still recorded net outflows of US$6.3bn for the month of April.

Downside Risks Remain, but EMs Should be Differentiated

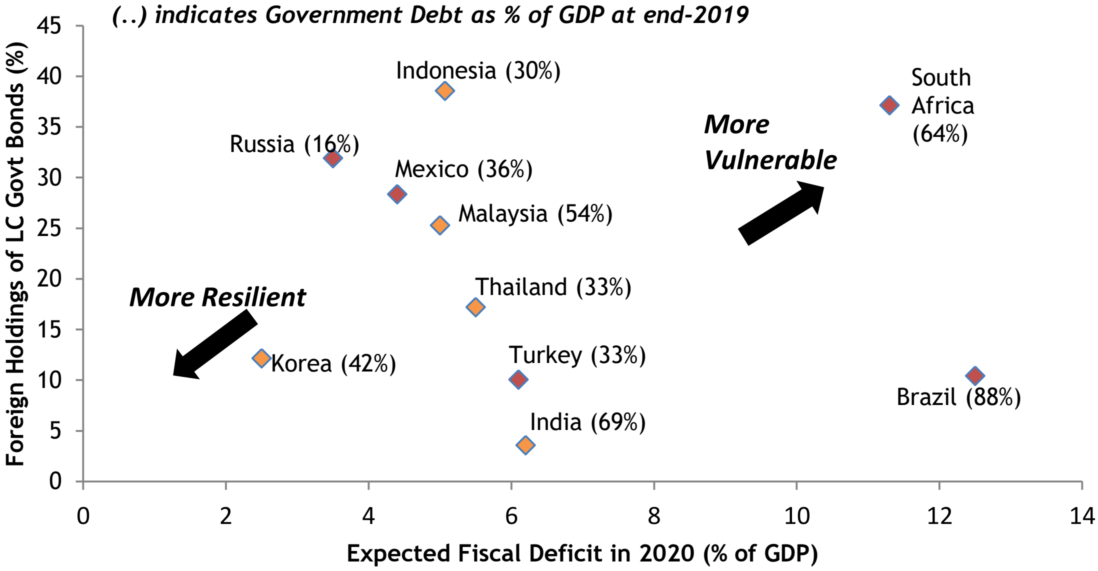
The Institute of International Finance (IIF) specifically highlighted EM refinancing risks in the current environment, estimating that "over US$20trn of global bonds and loans come due through end-2020; $4.3trn of that in EMs." Through end-2020, EMs will need to refinance around $730 billion in foreign currency-denominated debt.

Broad market consensus already sees public debt ballooning in 2020. As global lockdowns dent corporate earnings and add to job losses, governments around the world are responding with increasing levels of fiscal stimulus, largely with the intent of avoiding corporate closures and downward spirals in jobs and demand.

Even as economies around the world prepare to ease lockdown restrictions, social distancing measures and other travel restrictions could still weigh on private consumption. It will also take time for currently displaced personnel to re-match with new jobs, adding to transitory frictions in the labor market. Concomitantly, traditional sources of government revenue in the form of consumption, income, corporate taxes etc. will be under pressure for several quarters ahead even if direct risks from Covid-19 contagion are managed well.

While public financing needs tend to be larger in EM economies, there are various levels of differentiation in fiscal risks. We plot an indicator of reliance on external financing (i.e., foreign holdings' share of domestic local currency government bonds) vs. an indicator of the immediate need for extra funding (i.e., expected fiscal deficit in 2020).

Except for ID, Asian EMs (orange) Broadly Less Exposed to External Funding Stresses in Near Term



Source: IIF, Maybank FX Research & Strategy
Note: Expected fiscal deficits for 2020 are compiled from mix of fiscal authorities, rating agencies and consensus analyst estimates.

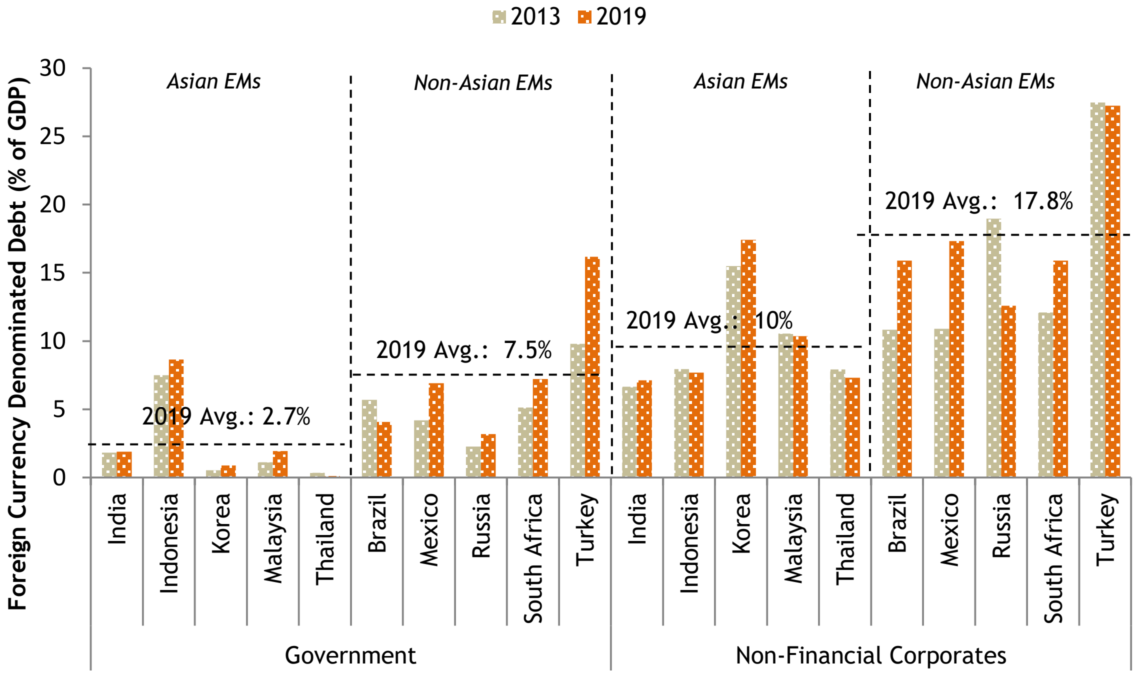
We note that South Africa is a clear outlier in terms of external funding risks. It has a large immediate need for funding, as well as a significant reliance on foreign funds in domestic debt issuances. Poorer performances among its large SOEs could add to need for fund injections by the government, further adding to fiscal pressures.

Focusing on the Asian EMs, indicators are somewhat mixed, but on the whole more positive versus non-Asian EMs. India, Korea and Thailand seem less exposed to these risks. In particular, India's predominantly local investor base could facilitate ease of higher borrowing in the near-term, despite a larger expected fiscal deficit this year.

Both Malaysia and Indonesia are on par in terms of expected fiscal spending needs at this point (Indonesia has relaxed its 3% legal cap in deficit spending for three years), but we note that Indonesia relies on external financing to a greater extent. One redeeming factor though, is that Indonesia's government debt to GDP is considered relatively low among global EMs at around 30%.

We now turn to a somewhat different risk factor, that of potential currency mismatches in debt. While the bulk of borrowings among EMs are local-currency denominated, certain countries buck the trend. In times of crisis, sharp declines in domestic currency strength versus USD or other majors could result in significantly higher repayment costs, adding to fiscal stresses among sovereigns and corporates alike.

Asian EMs Likely More Resilient to FX Mismatch Risks in Debt



Source: IIF, Maybank FX Research & Strategy

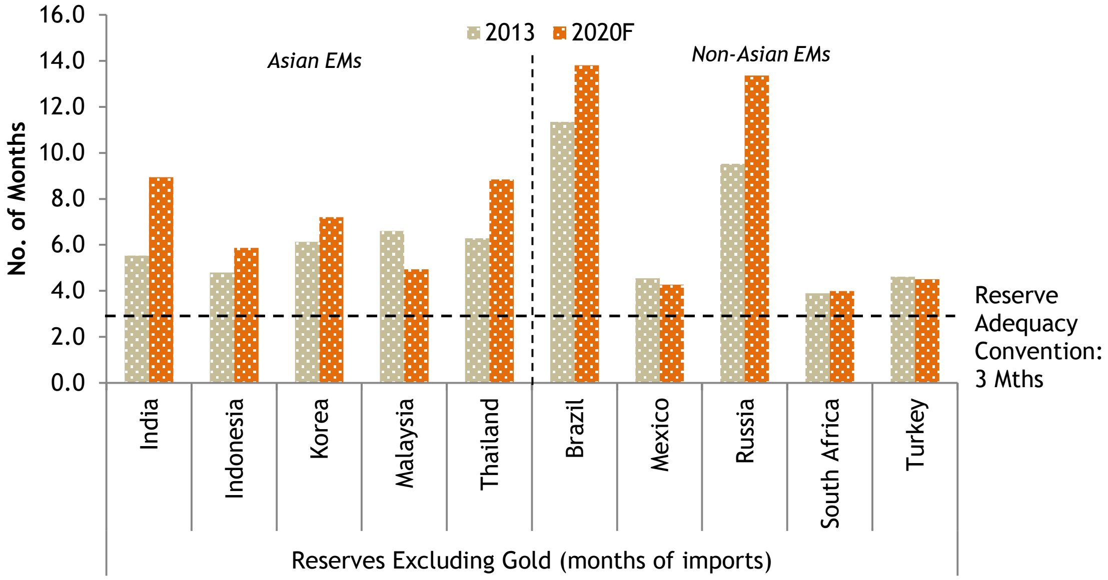
There are a few revelations from the chart above. First, exposure to foreign currency denominated (mostly USD) government debt is lower among Asian EMs vs. other EMs, with the exception of Indonesia. Issuances of government debt in India, Korea, Malaysia and Thailand are largely in local currency terms.

Two, while the shares of foreign currency denominated debt rises significantly when we look at Asian corporate issuances (vs. Asian sovereigns), levels are still broadly lower compared to non-Asian EMs. FX mismatch risks for Korean corporates appear to be higher compared to regional peers, but should remain manageable overall given that softening in KRW vs. USD over the current crisis is only around -4%, compared to double digit depreciations for non-Asian EM FX.

Three, comparing end-period outcomes in 2019 and 2013 (taper tantrum), reliance on foreign currency funding largely remained the same or increased slightly for Asian EMs, while that in other EMs such as Brazil (corporates), Mexico (sovereign and corporates), South Africa (sovereign and corporates) and Turkey (sovereign) saw significantly higher reliance and hence FX mismatch risks.

One other relevant factor to consider is the level of reserve adequacy. Conventional "rule of thumb" used to guide reserve adequacy suggests that countries should hold reserves covering at least 3 months' worth of imports.

Differences in Reserve Adequacy More Stark Among Non-Asian EMs



Source: IIF, Bloomberg, Maybank FX Research & Strategy
Note: Estimates for 2020 are by IIF.

All the countries we examine here have reserves which can cover more than 3 months of imports. However, among non-Asian EMs, Mexico, South Africa and Turkey are clearly more at risk compared to Brazil and Russia.

Among Asian EMs, most countries (except Malaysia) saw improvements in this metric between 2013 (taper tantrum) and 2020, with estimated import cover at around 6-9 months' worth.

We summarize the above discussions in a convenient heat-map (deeper shade of red indicates higher vulnerability).

	Fiscal Deficit, 2020F (% of GDP)	Foreign Holdings' Share in LC Govt Bonds (%)	Govt Debt (% of GDP)	Foreign Curr. Denominated Govt Debt (% of GDP)	Foreign Curr. Denominated NFC Debt (% of GDP)	Reserves' Import Cover (No. of Mths)
India	6.2	3.6	69.0	1.9	7.1	8.9
Indonesia	5.1	38.6	30.2	8.7	7.7	5.9
Korea	2.5	12.2	41.6	0.9	17.4	7.2
Malaysia	5.0	25.3	54.1	1.9	10.4	4.9
Thailand	5.5	17.2	33.3	0.1	7.3	8.8
Brazil	12.5	10.4	88.5	4.1	15.9	13.8
Mexico	4.4	28.4	36.4	6.9	17.3	4.3
Russia	3.5	31.9	15.7	3.2	12.6	13.4
South Africa	11.3	37.1	64.1	7.2	15.9	4.0
Turkey	6.1	10.1	32.6	16.2	27.3	4.5

Source: IIF, Bloomberg, Maybank FX Research & Strategy

Overall, among non-Asian EMs, South Africa and Turkey seem most vulnerable to risk of deterioration in fiscal conditions. Brazil also stands out in part due to its significantly higher expected fiscal deficit this year (around 12.5% of GDP vs. around 5.9% in 2019) and high current level of government debt. **Asian EMs are broadly more resilient, with Indonesia's higher reliance on external funding being a modest risk to watch out for.**

We note too that current fiscal trends will likely have an interactive effect with contagion developments. I.e., the more persistent the Covid-19 contagion domestically, the longer restrictions on businesses and movements have to be kept in place, the larger the temporal displacements in jobs, and the greater the fiscal stimulus required to support the economy.

On this front, we note that Asian EMs are broadly performing better than other EMs too. With the exception of India and Indonesia, new case counts in Korea, Malaysia and Thailand have slowed significantly. Meanwhile, contagion risks remain broadly higher in non-Asian EMs. New case counts daily continue to number in the thousands for Mexico, Turkey, Brazil and Russia, with Russia's daily new cases breaching the 10,000 mark over 4th to 7th May. While South Africa's 5-day average looks more manageable at just below 400, there is a potential uptrend.

One key concern though, is that if there is an EM meltdown beginning in South Africa, Turkey or even Brazil, global investors may decide to exercise a broad withdrawal of funds from across EM bond or equity funds. A synchronous episode of portfolio outflows was seen in March this year (chart on page 15) as sentiments soured, and the possibility of another episode of positive correlation in outflows cannot be discounted, especially if the overall EM fiscal narrative worsens going forward. I.e., EM Asian assets likely will not escape unscathed if fiscal crises deepen in non-Asian EMS, even if the extent of drag could be less painful.

One broad mitigating factor now is that governments, central banks, supranationals and multilateral lenders appear more ready than ever to inject funding wherever there are signs of trouble. Fed's earlier quick establishment of dollar swap lines outside of the US helped ease dollar liquidity crunches globally. The ADB recently tripled its Covid-19 facility to US$20bn and the AIIB doubled its programme to US$10bn. In March, World Bank also implemented an increased US$14bn package of fast-track financing to assist companies and countries in their Covid-19 efforts. It also expects to "deploy up to US$160bn over the next 15 months to help countries protect the poor and vulnerable, support businesses, and bolster economic recovery". These efforts could work towards preventing the worst macro outcomes from materializing, especially among EMs.

Conclusion

In the first part of this report, we examine the current episode of equity recovery and note that the pace of rebound is well above that observed in past crises. At this point, we are cautiously optimistic on a broad perspective—on the back of policy stimulus, progress in vaccine development and a lower bar for upside surprises in economic data—but acknowledge that a multitude of risk factors can threaten to derail the recovery.

On signs of re-emergence in tensions between US and China, we outline reasons for why US' bark may be worse than its bite at this point, with fragile domestic consumption in particular limiting further tariff penalties that the Trump administration can consider. We also note that underlying conditions (growth convergence, aggressive Fed easing) could mean that the blow to APAC-ex JPY currencies vs. USD may not be as large as before even if tensions rise again.

With regards to EM fiscal vulnerabilities, an analysis of specific debt and reserve metrics suggests that potential drags to sentiments on this front are more significant for non-Asian EMs, especially South Africa and Turkey at this stage. EM Asia looks to be in a better position to weather Covid-led fiscal stresses in general, even as we continue to monitor Indonesia's higher reliance on external funding with care.

On net, while the confluence of risk factors remains dynamic, we think that current developments have yet to derail our prior preference for tech-linked Asian FX such as TWD, KRW, as well as SGD. Resumption in underlying tech trends should be sustained in the months ahead still. However, we like to note KRW's sensitivity to trade tensions and EM vulnerabilities via the sentiment channel. As such, a strong manifestation of any of the risks above could overwhelm fundamentals for KRW.

For IDR, we remain positive on a longer-term basis but risk-reward may not be optimal for long positions at this point.

We continue to favor JPY longs as a hedge. Recent attempts at USDJPY rallies have quickly lost momentum and retraced lower, as markets increasingly demand protection against a myriad of risk factors.

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