FX Insight

Stay the Course but Mind the Bumps

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USD Strength to Fade; Pro-cyclical, Commodity FX to Rise

USD remains better bid in recent weeks—on bouts of risk aversion due to (1) global bond sell-off spilling over to other asset classes including equities and broader sentiment; (2) divergence of covid improvement, inoculation pace and relative growth outperformance in favour of US and (3) Biden's $1.9 stimulus to support growth (which could be passed as early as mid-Mar).

But we **expect USD support to be moderate and temporary**. More turmoil in the treasury markets may be averted with sufficiently strong Fed reassurance. **As long as the pace of US yield increases reverts to a more manageable, gradual trajectory, any interim boost to USD could slowly fade alongside**. Concerns of a repeat of **taper tantrum 2013** that affected EMs then are likely overhyped (or at the very least premature) given marked difference in sources of US yield increases, policy settings, macroeconomic situations and portfolio flow momentums when we compare the environment now and 2013. Broader market thematic of reflation, commodity rebound, vaccine trade remains in play, notwithstanding intermittent profit-taking. **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. **Bias still to stay long AUDJPY** and look to add AUDTHB on dips.

Bear Steepening Episodes See AUDJPY Rise the Most

We observed that bear steepening episodes in the past 20 years saw little effect on the USD while AUD, CAD, NZD, GBP did better. AUDJPY, in particular, gets the biggest boost while Asian currencies (especially INR, IDR) weakened a tad.

Spikes in UST Yields Can Undermine Asia FX

We then looked deeper into the historical episodes of UST yield spikes in 2013, 2015 and 2016, we derive a few quick findings: (i) a spike in UST yield usually leads to immediate upsides for the dollar (DXY) in the same month; (ii) but if the pace of yield increase slows or reverses over the next three months (as is usually the case), upsides for the USD may be contained or retrace as well; (iii)) among AxJ FX, yield sensitive IDR and INR react most negatively to UST yield spikes. **Taken together, these findings could suggest that as long as the pace of yield increases reverts to a more manageable, gradual trajectory, the boost to USD could slowly fade alongside**.

Reflation Thematic Playing Out

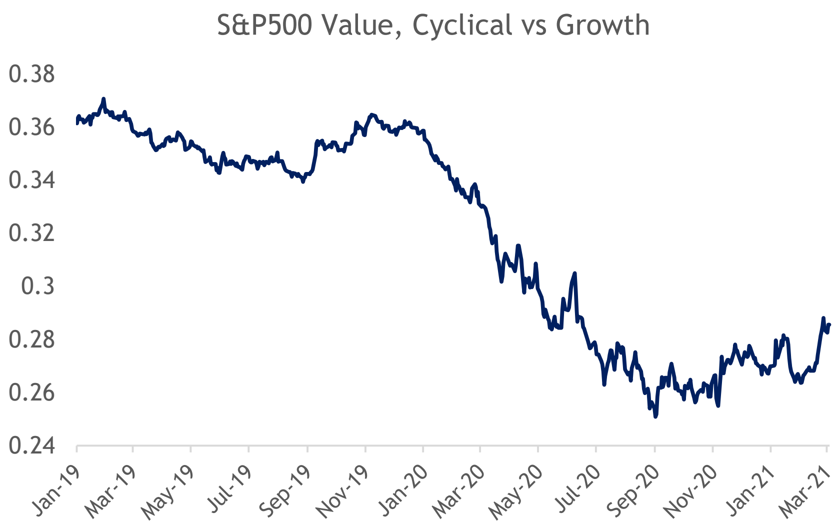
Taking stock, cross asset market price action suggests that the reflation thematic is growing more entrenched.

Year-to-date, yield curves bear steepened, with 2y10y UST yield differentials widening by over 50bps to 4-year high of around 130bps while yields rose sharply by over 70bps to 1.61% at one point (25 Feb).

Commodities outperformed with CRB index rising over 16% at one point. Amongst the commodity complex, oil prices took the lead (>+20%), followed by hard commodity, copper, iron ore (+16%) while soft commodity, cotton and lumber were up more than 10% YTD.

Gains in global equities were uneven with Asian equities, including Nikkei, Hang Seng, Taiex, Nifty (up between 5% and 9%) outperforming US, European indices (up between 2% and 5%). On sectoral shifts, S&P cyclical and value stocks are showing tentative signs of relative bottoming against S&P growth stocks with the ratio finding a bottom (around Sep-2020) and rebounding as markets position for post-pandemic cyclical rebound.

S&P500 Value and Cyclical Bottoming against S&P500 Growth (Positioning for post-pandemic Cyclical Rebound)



Note: Average of S&P 500 value and cyclical index was averaged before computing the ratio with value and cyclical as numerator (a proxy for cyclical shifts) while S&P growth as denominator. As of 3 Mar 2021.

Source: Bloomberg, Maybank FX Research & Stategy

Global vaccine roll-out has been the main catalyst, fuelling hopes of lockdowns, restrictions being lifted soon as covid pandemic shows signs of being contained. Global daily infection has fallen by more than 50% from its peak in mid-Jan and the improvement in covid situation is broadly seen across most countries including some of the worst hit countries like US, India, UK. Over the past 2 weeks, more countries in the region have also started to roll out vaccines, including NZ on 19 Feb (a month ahead of schedule), Australia on 22 Feb and to roll out AstraZeneca vaccine from 8 Mar, Malaysia begun nationwide inoculation with Pfizer-BioNTech vaccine on 24 Feb and had recently (2 Mar) granted conditional approval for the use of vaccines made by UK's AstraZeneca and China's Sinovac, S.Korea started the use of both Pfizer and AstraZeneca vaccines end-Feb, with the goal of reaching herd immunity by Nov-2020 while Thailand is the latest to begin inoculation (1 Mar) with China's Sinovac.

Impact on FX Less Clear Cut and Uneven But…

Given higher volatility across multi-asset classes, sharp rise in UST yield and reflation thematic gathering traction, the collective impact on FX is uneven and some currencies stood out more. YTD, GBP and commodity-linked FX such as AUD, NZD and CAD outperformed (on reflation/vaccine thematic) while most AXJs including high-beta AXJs, INR, IDR and KRW underperformed (rapid pace of sharp increase in UST yield and sustained covid infection in South Korea is likely to have undermined sentiment). Elsewhere, USD saw mixed performance.

… Do Not Expect AXJs to Behave Like in 2013's Taper Tantrum Episode

The source of yield spikes matters. In 2013's taper tantrum episode, yield move higher was driven by then Fed Chair Bernanke's first explicit warning of future QE tapering (back in May-2013) and subsequently, FX markets reacted with USD firmer while INR and IDR led declines in the AXJ space.

In the current episode where there were some commentaries drawing parallels to 2013 taper tantrum, raising concerns that AXJs may come under pressure.

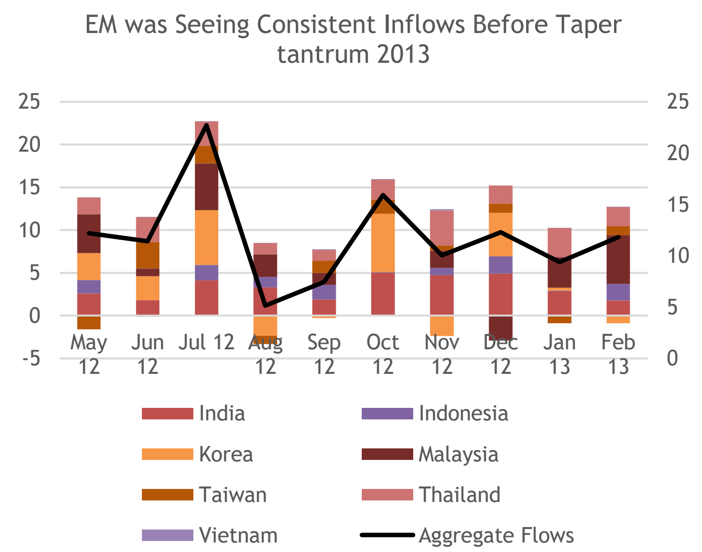
We acknowledged that **there may be some temporary softness for AXJs** (given the sharp spikes in yields) **but not a 2013 déjà vu moment for AXJs**, for now. The source of yield increase this time round was driven by markets re-pricing for an exit out of covid pandemic (given roll-out of vaccines globally) and for a sharper global economic rebound, inflation upticks (and from low bases).

- The policy setting today is also different from 2013. Policymakers today are still focused on fiscal stimulus, in attempt to secure a stronger economic and jobs recovery. On monetary policy stance, central bankers have been synchronously focused on keeping policy stance easy for longer. For instance, Fed introduced Average Inflation Targeting regime with tolerance for inflation overshoots, RBA, BoJ aim to anchor the cost of borrowing by adopting yield curve control (YCC) while BoE, RBNZ, BoC, ECB and Fed are still on QE and have said that it remains too early at this stage to discuss tapering – a stark difference from 2013, when Fed explicitly mentioned QE. In recent weeks, RBA and BoK even added its bond purchases.
- In terms of macroeconomic environment, it is also different today vs. 2013. According to IMF World Economic Outlook (Oct-2013), the paper described global growth in low gear and Emerging market economies faced the dual challenges of slowing growth and tighter financial conditions. But for 2021, IMF World Economic Outlook (Jan-2021) projected the global economy to

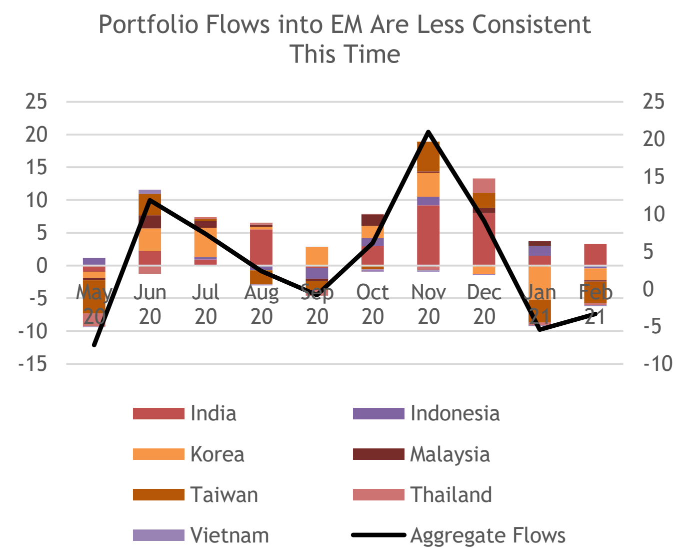
grow 5.5%. In fact, the growth outlook was revised higher by 0.3ppts reflecting *expectations of vaccine-powered strengthening of activity later in the year and additional policy support in a few large economies*.

- From the flows perspective, there are marked difference as well. Back in 2013, taper tantrum occurred after years of quantitative easing that began in 2008. During that period, low growth and low rate environment had driven portfolio flows into the region on the hunt for yield. While the unprecedented scale of synchronous monetary easing since 2020 have likely driven flows into the region once again, the presence of massive fiscal support along with the mass vaccination efforts have spurred expectations of reflation within just one year after the Fed restarted QE in Mar. That has naturally capped the amount of inflows into the region and resulted in the scale-down that we saw at the start of the year. According to IIF estimates, total portfolio flows into EM surged in 4Q 2020 (with EM x China flows totalling $86.1bn in Nov-Dec) but the scale of capital inflows have declined substantially to just $21.5bn recorded. Longer-dated observations show rather strong and consistent portfolio inflows into EM countries in the months leading up to Taper Tantrum 2013. However, portfolio flows into EM are less consistent this time round with more occurrence of outflows in the past 10 months. This suggests that any taper tantrum that may come into effect could have more subdued reaction.

EM portfolio Flows were Strong and Consistent before Taper Tantrum 2013 (one way)



Portfolio flows are Less Consistent This Time With More Occurrence of Outflows in the Past 10 months (two-way)

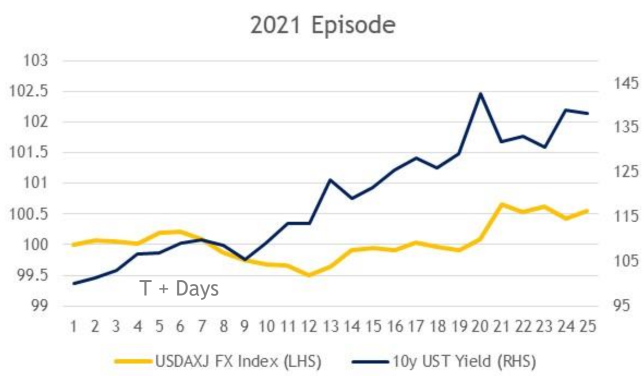


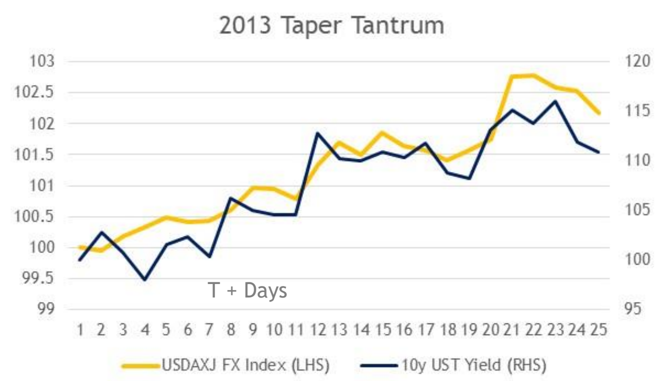
Source: IIF, Sovereign Data, Maybank FX Research & Strategy
Note: Monthly country-level figures should be interpreted carefully, as they might not be fully in line with official quarterly BOP figures. Net non-resident purchases of EM stocks ("portfolio equity flows") and bonds ("portfolio debt flows") in USD million. Proxy for portfolio flows as measured in the balance of payments. Aggregate flows is the sum of debt and equity flows (estimates) of the respective sovereigns seen here. The Korea debt data is only available until Dec 2020.

In a way both 2013 and 2021 episodes saw yield increases but we cannot casually draw parallels of the current episode to 2013 taper tantrum. The source of yield increase then and now is different, with the 2013 episode driven by supply and the 2021 episode driven by demand. In addition, the current episode is also seeing nascent signs of commodity and semiconductor supercycles that should bode well for selected Asian economies, such as Australia, South Korea and Taiwan but less so for India (sensitive to oil price increases).

In the 2 charts below, we compared the episodes of UST yield increases and USD/AXJ FX changes (T+25 days so far). For the same period (T+25days), 2013 taper tantrum saw 10y UST yield rising by 10 – 15% and a correspondent decline in AXJ FX by 2% - 3% (vs USD). Fast forward to 2021, we saw a sharper rise in 10y UST yield by around 40% while AXJ FX declined by a mere 0.6%.

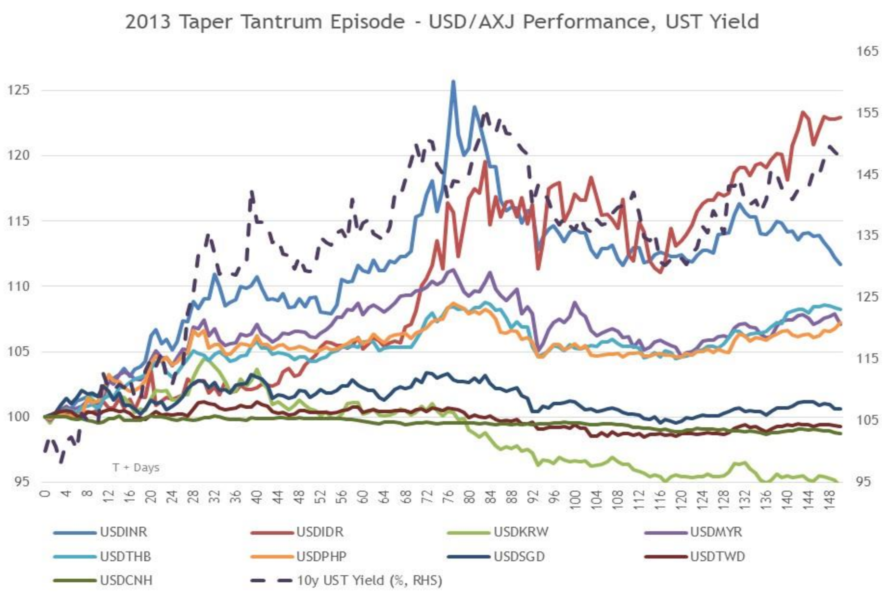
Decline in AXJ FX Far More Subdued vs. 2013 while UST Yield Rise is Way Sharper This Time vs. 2013





Note: USD/AXJ FX Index is made up of USD vs. equal weighted of INR, IDR, KRW, MYR, THB, PHP, SGD, TWD, CNH, indexed to 100 on start of respective episodes of yield upticks. T for 2013 Taper tantrum period start from 13 May 2013; T for 2021 episode start date = 29 Jan 2021.
Source: Bloomberg, Maybank FX Research & Strategy

Recap of USD/AXJ FX Performance During 2013 Taper Tantrum



Source: Bloomberg, Maybank FX Research & Strategy

FX Performance in Different Yield Curve Regimes and Pace of Yield Increases

Next, we look at 2 moving parts in detail: (1) Yield curve regimes and typical FX behaviour and (2) Pace of Yield Increase – if it matters and its impact on FX.

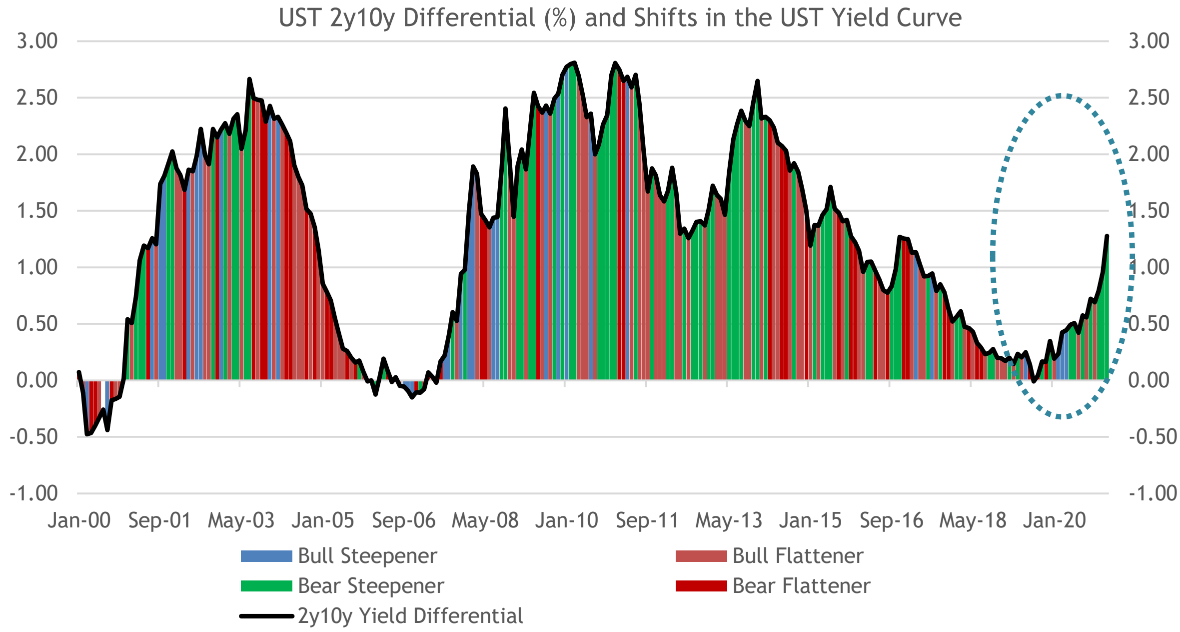
Our current environment can be described as a bear steepening environment. In Feb alone, UST 10y yield had risen >30bps (the biggest monthly gain since Nov 2016 while the front end remains anchored by expectations of the Fed to keep rates low for longer (especially in light of Fed's Average Inflation Targeting regime). In this section, we looked at how currencies behaved in the four regimes since Jan 2000 and we pay particular attention on the bear steepening environment that is characteristic of reflation, as aggressive fiscal stimulus, accommodative monetary policies as well as hope offered by the roll-out of vaccine spur a potentially dramatic rise in activity and global demand.

What Can the Yield Curve Tell Us?

The yield curve has been known as a business cycle indicator and the term spread is known to reflect (and sometimes even forecast) economic activity. Shape of the yield curve is typically affected by yield movements and the differential pace of these movements between the short-term and long-term yield. For analytical purpose, we sort the term structure into these four curve changes and look at how currencies behave in each of these regimes.

1. **Bear steepening -** interest rates rising, yield curve steepens as long term interest rates rise faster than short-term interest rates (reflationary)
2. **Bull steepening** – interest rates falling, yield curve steepens as short-term interest rates fall faster than long-term interest rates
3. **Bear flattening** – Interest rates rising, yield curve flattens as short-term interest rates rise faster than long-term interest rates
4. **Bull flattening** – interest rates falling, yield curve flattens as long-term interest rates fall faster than short-term interest rates.

The UST Curve had mostly Bear Steepened Recently as Reflation Narrative Gains Traction



Source: Bloomberg, Maybank FX Research & Strategy
Note: The four type of yield curve changes are defined based on the monthly changes of 2y10y differential.

Historical FX Behavior to Shifts in Different Yield Curve Regimes

	Bear Steepen	Bull Steepen	Bear Flatten	Bull Flatten
DXY	-0.04	-0.93	0.27	0.09
AUDJPY	1.11	-1.55	0.83	-0.45
JPYUSD	-0.75	1.66	-0.96	0.71
EURUSD	0.15	1.12	-0.13	-0.06
GBPUSD	0.49	0.57	-0.19	-0.55
AUDUSD	0.29	0.05	-0.15	0.21
NZDUSD	0.42	0.00	-0.40	0.46
CADUSD	0.59	-0.16	-0.04	-0.13
CNYUSD	0.19	0.25	-0.16	0.13
KRWUSD	-0.06	0.58	-0.10	0.10
TWDUSD	0.12	0.43	-0.14	-0.02
SGDUSD	0.06	0.44	-0.16	0.19
MYRUSD	0.13	0.05	-0.25	0.01
IDRUSD	-0.32	0.35	-0.60	-0.02
THBUSD	0.17	0.29	0.06	0.11
PHPUSD	0.02	0.01	-0.18	-0.04
INRUSD	-0.29	0.05	-0.26	-0.09

Note: All yield curve regimes are defined by changes in the 2y10y spread and the above data (2000-2020) are **average monthly changes** for each currency pair. For example, the DXY index declines by an average of -0.93% in months when the US Sovereign curve bull steepened. Bull steepening is defined by a fall in interest rates and a rise in the 2y10y yield spread.

Source: Maybank FX Research & Strategy, Bloomberg

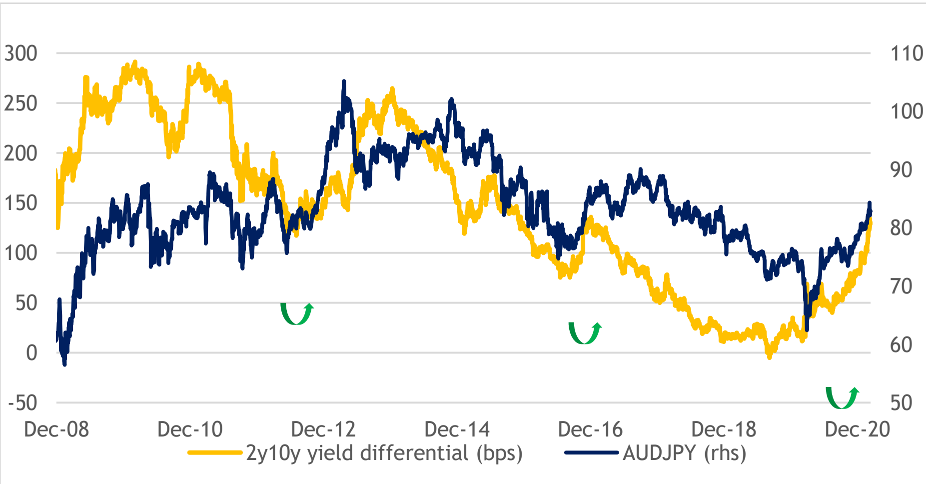
Our study reveals that in periods of bear steepening (interest rates rising, yield curve steeper), AUDJPY strengthened the most (gaining +1.1% on average) relative to other currency pairs and vs. its own performance in other regimes. This is in line with conventional wisdom as AUDJPY tends to be seen as a barometer of reflation. Along with the reflation that is ongoing across the world, the rise in activity, infrastructure projects that include fresh green initiatives in major developed economies, improvement in investor and consumer confidence that are bolstered by fiscal support, would inevitably lift the demand for resources. Observations in the past two decades saw **DM commodity currencies such as the AUD, NZD, CAD and to some extent, GBP (typically has a positive correlation with oil) appreciating substantially in past episodes of bear steepening of the US sovereign curve.**

The Commodity Supercycle Adds Booster Shots to AUD, CAD, NZD

In this current period, commodity-linked currencies are boosted all the more by the COVID-19 pandemic that spurred sovereigns around the world to make stronger commitments towards climate change. That has also formed the foundation for the Commodity Supercycle that can take commodity-linked FX such as AUD, NZD and CAD on a pro-longed uptrend, notwithstanding potential sporadic corrections. To some extent, these currencies have already logged significant gains but we remain constructive on these currencies for the rest of 2021. We continue to remain particularly bullish on the AUD given its inextricable fate with base metals and potential benefits as the world shifts towards a sustainable future with more electric vehicles. 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 bode well for its terms of trade.

Taken together, an environment such as this could mean muted action for the ASEAN FX currencies vs. strong beneficiaries DM commodity FX (AUD, NZD and CAD). We also note a bear steepening regime typically has little bearing on the USD, possibly due to the fact that the positive effect of the rise in US rates could be negated by the countercyclical nature of the USD.

AUDJPY Already On the Rise on Reflation Plays



Source: Bloomberg, Maybank FX Research & Strategy

Pace of Yield Moves Matters for Near Term FX Impact

Besides the broad phase of yield curve regimes, the pace of yield curve changes matters as well.

Using UST10Y yield as an example, it rose by around 1.066% to 1.405%, a move of 0.34%-pt. Notably, in terms of **pace**, this was the 5th fastest monthly rise in UST10Y yields since 2011.

Concomitantly, dollar was rather supported in the month. Does this display of rising yields necessarily indicate a shift in USD's downtrend? And does it shift our baseline for modest USD downsides in the year ahead (DXY to below 88 by year end)?

Historical Episodes of UST 10Y Yield Spikes

	%-pt Change per Mth	% Change per Mth									
Episode	**UST 10Y Yield**	**DXY**	**SGD**	**MYR**	**IDR**	**THB**	**PHP**	**CNH**	**KRW**	**TWD**	**INR**
May 2013	0.46	1.99	-2.57	-1.80	-0.74	-3.76	-2.68	0.18	-2.68	-1.59	-5.24
Next 3 Mths	0.22	-0.51	-0.27	-2.09	-4.58	-1.85	-1.69	0.18	0.64	0.04	-5.25
Feb 2015	0.35	0.52	-0.65	0.47	-2.01	1.02	0.44	-0.13	0.10	0.82	0.86
Next 3 Mths	0.04	0.61	0.41	-0.31	-0.53	-1.34	-0.34	0.46	-0.35	0.67	-1.16
Nov 2016	0.56	3.10	-2.96	-6.04	-3.97	-1.75	-2.82	-1.97	-2.89	-1.29	-2.79
Next 3 Mths	0.00	-0.11	0.73	0.20	0.55	0.69	-0.27	0.31	1.24	1.39	0.90
Feb 2021	0.34	0.33	-0.28	-0.16	-2.08	-1.80	-1.30	-0.45	-0.60	0.51	-1.36
Next 3 Mths	-	-	-	-	-	-	-	-	-	-	-

Note: All changes are in monthly changes, or average monthly changes. Except for DXY, FX changes are measured against the USD. Table as of 3 Mar 2021.

Source: Maybank FX Research & Strategy, Bloomberg

The table above shows some historical episodes of UST 10Y yield spikes, the concomitant changes in FX during those episodes, as well as outcomes in the subsequent 3 months from the initial spike.

Looking at the table above, we derive some quick findings:

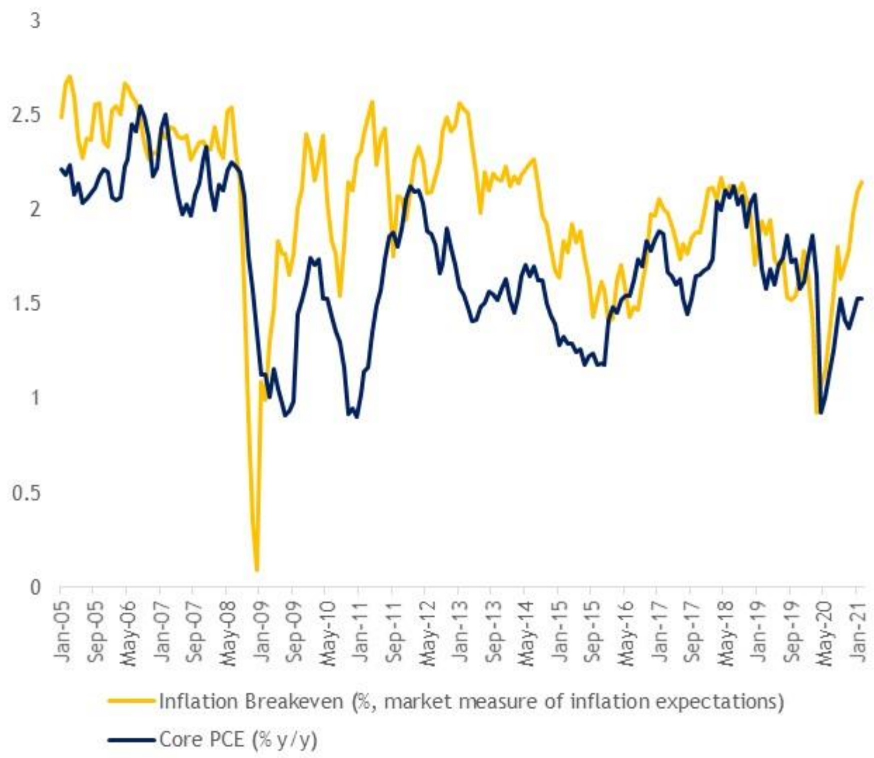
- A spike in UST yield usually leads to immediate upsides for the dollar (DXY) in the same month.
- But if the pace of yield increase slows or reverses over the next three months, upsides for the USD may be contained or retrace as well.
- On average among AxJ FX, **yield sensitive IDR and INR expectedly react most negatively to UST yield spikes**. But in the case of 2015 and 2016, when the treasury markets calmed down after the initial month, drags on IDR and INR sentiments may similarly be contained or fade. Drags were more persistent in the 2013 taper tantrum episode when yields rose continuously from May to Aug.

Taken together, these findings could suggest that US yields do not necessarily need to retrace sharply lower for us to see more USD downsides. As long as the pace of yield increases reverts to a more manageable, gradual trajectory, the boost to USD could slowly fade alongside.

Risk to Watch – Inflation

The one big concern at this point is markets' fear for sharper inflation ahead and an earlier than expected timeline in central bank normalizing monetary policies, hence contributing to the large spike in 10Y yield to 1.61% last week. 10Y US breakeven (market-measure proxy of inflation expectation) has risen to 2.2%, from around 0.5% back in Mar-2020 while upcoming CPI releases could see upticks on low base effects, surge in demand as economy reopens and restrictions are gradually lifted. On the latter, it is highly likely to anticipate price upticks but on the former, there is some shortcoming in using breakeven alone as an expectations indicator of price increases as breakeven is the yield gap between US TIPS and conventional bonds of the same maturity. TIPs can be an illiquid product at times and subjected to market distortion. Fed owns more than 23% of the entire TIPs market and Peterson Institute for International Economics (PIIE) earlier noted that many of central bank's purchase of TIPs were concentrated in the 5-year area where the inflation-indexed yield had plunged and thus pushed breakeven rates higher. Also Bloomberg ran an article last Fri describing how the chaotic treasury selloff (sharp rise in bond yield) was fuelled by $50bn of unwinding, supply indigestion with thinning of market liquidity exacerbating moves.

Inflation Expectations on the Rise, by Market-Based Measure Metric



Source: Bloomberg, Maybank FX Research & Strategy

Hence **central bankers' reassurance is key to calm sentiments** for now. Already Fed's has indicated the shift towards average inflation targeting (AIT) regime and to look past overshoots in inflation and unemployment rate. In Fed Chair Powell's semi-annual testimony to Congress (23 and 24 Feb), Powell acknowledged that some asset prices are elevated by some measures (referring to examples of higher car prices due to supply-side constraints including chip shortages), but this does not necessarily lead to inflation as "inflation is a process that repeats itself year over year over year" instead of a one-time surge. Basically, if inflation is one-off (or transitory), policymakers will allow for patience and keep policy accommodative for longer.

However, if upward price pressures are sustained for longer than expected, alongside sustained growth rebound, then policymakers are likely to then react with interest rate hikes at some stage in the future and this requires time to monitor.

For now, a slower pace of price pick-up (CPI inflation, wage price, etc.), pandemic showing more signs of being contained and reassurance from the Fed and other central banks (on keeping monetary policy status quo or adding to bond purchases such as RBA, BOK in recent days) will be crucial to calm sentiment, alleviate market stresses and to find back the sweet spot for risk assets to resume their trajectory.

Concluding Remarks – Still Bias for Moderate USD Softness Not Withstanding Intermittent Spikes

On net, the next phase of market moves could be anchored on market interpretation of near-term inflation data and Fed messaging.

USD saw support in recent weeks—on bouts of risk aversion due to (1) global bond sell-off spilling over to other asset classes including equities and broader sentiment; (2) divergence of covid improvement, inoculation pace and relative growth outperformance in favour of US and (3) Biden's $1.9 stimulus to support growth (which could be passed as early as mid-Mar). **But we expect this USD support to be moderate and temporary**. More turmoil in the treasury markets may be averted with sufficiently strong Fed reassurance. **As long as the pace of US yield increases reverts to a more manageable, gradual trajectory, any interim boost to USD could slowly fade alongside**.

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. Bias still to stay long AUDJPY, targeting 90-levels medium-term objective (our earlier call has met 83.10 objective).

We also prefer to long AUDTHB, taking advantage of the difference in beta, political uncertainties in Thailand that could add further boost to this cross as cyclical recovery takes hold. While AUDTHB could see further declines towards 23.42 (21-dma) before the 23.20. We prefer to buy this cross on dips towards 23.20 for the target of 24.30 before 25.18. Stoploss at 22.80. Risk reward ratio of 1:2.75.

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