Maybank

Macro | FX Research and Strategy

Global

FX Insight

AXJs in the Face of Dovish PBoC and Hawkish Fed

ASEAN-G3 Growth Convergence Accelerates ASEAN Policy Normalisation

Markets had a choppy start to the year amid omicron spread, escalation in geopolitical tensions in some parts of the world and policy winds of change with Fed sounding more hawkish at every FoMC, stringing other central banks to tighten while PBoC cut rates.

We believe ASEAN sentiments might still be supported overall as most of ASEAN should see a modest rebound in growth momentum this year, with higher vaccination rates and Covid-endemic policies helping to buffer economic health from swings in Covid case trajectories. The ASEAN growth "catch-up" provides a foundation of more robust macro fundamentals from which some Asian central banks can begin to contemplate an earlier withdrawal of monetary policy stimulus. In a broad sense, less-divergent policy paths between some regional central banks and the Fed could mean lower likelihood of outsized drags on AxJ FX despite Fed tightening concerns.

On Fed policy and dollar index (DXY), we find that lead-up to first Fed hike tends to drive DXY upwards but DXY typically fall between 2% and 4% on average post-Fed first hike.

Five Opportunistic Strategies to Capture Multiple Thematics

Based on our findings and analysis from the report on Fed rate hike cycles, PBoC moves, central bank divergence, flows and positioning and technical indicators, we see a handful of opportunistic FX proxy plays, on a relative bilateral basis and via basket trades that can be strategic (beyond 3 months), tactical (up to 3 months) and technical (1 -2 weeks). We have 5 main categories below. Please see pages 20-22 for further elaboration.

Themes	FX Strategies
Covid-endemic, Reopening Play	Focus on Covid-endemic (less econ. drags) vs. zero-Covid policy stance in countries. Basket of equal-weighted long SGD, THB, KRW, vs. short TWD, CNH.
G7-China Policy Divergence Play	Long CAD, AUD and NZD (potential rate hikes) vs. short CNH and JPY (easing spectrum).
Benign Commodity Outlook	Long AUD, IDR, MYR, CAD vs. short net energy importer INR. Demand could broaden post 1Q Omicron drags; geopolitical events risk impacting energy supplies.
Intra-ASEAN Policy Divergence Play	Tactical buy dips in SGD vs. short MYR, PHP. MAS first mover vs. slower normalization start for BNM, BSP. Buy dips preferred as S$NEER near top of policy band, long positioning near overcrowded.
USD - the Long and Short of It	Tactical long USD in the lead-up to first Fed hike but get ready to turn short post first hike as DXY typically fall 2% - 4%.

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Fed Tightening - Not a Show Stopper for AXJs

"We're really just going to be moving over the course of this year to a policy that is closer to normal, but it's a long road to normal from where we are now… It really should not have negative effects on the employment rate."

Jerome Powell, Fed Chair to Senate Banking Committee
11 Jan 2022

Markets have started the year in cautious and choppy fashion, characterised by sell-offs in USTs, US equities, notably tech counters while energy and metal prices rose to multi-year highs. USD had its ups and downs. Some of the key drivers behind the choppy start was due to expectations of Fed policy in light of persistent price pressures, omicron spread and accompanying pre-emptive restrictive measures being re-introduced in some parts of the world as well as deterioration in geopolitical tensions (attacks on UAE, Russia-Ukraine crisis, etc.)

In this report, we start by looking at the series of events that drove the ups and downs of the USD. We then look at Fed's quantitative tightening episode in 2017-19 and how it may or may not matter for the USD before taking a walk down memory lane to look at USD moves in the last 8 episodes of Fed tightening over the last 50 years. We suspect that if quantitative tightening did not affect financial conditions much over 2017-2019, the USD strength observed during that period might have been driven predominantly by the US-China trade war.

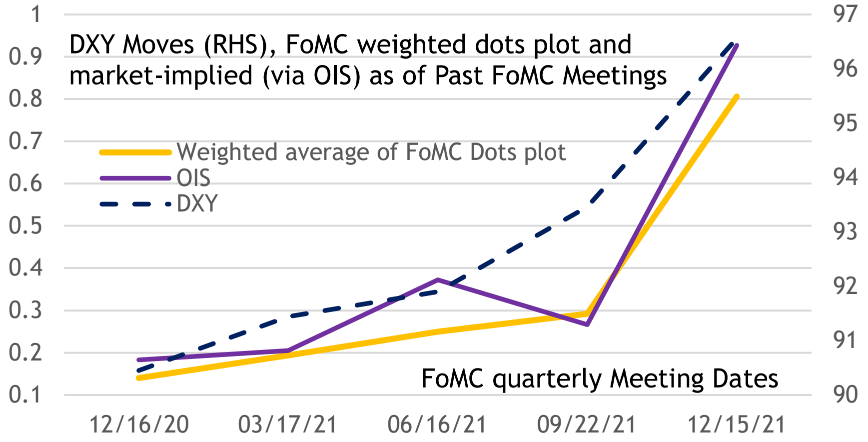
In a section dedicated to regional trends, we first discuss how ASEAN sentiments might still be supported overall by expectations for improving growth momentum this year, as opposed to signs of growth moderation in key economies such as US, Europe and China. This improvement provides the ASEAN-5 central banks with a more resilient set of macro fundamentals, upon which they can embark on or continue policy normalization efforts in 2022, albeit with different timings and magnitudes. We delve into what this implies for various FX, including what has likely been priced by markets. We also look at recent portfolio trends and relative FX positioning, teasing out overcrowded trades.

First-in-first-out China finds itself on a different business cycle vs. the rest of the world. PBoC has become an outlier on monetary policy which could see trade-weighted underperformance of the CNY and give rise to opportunities for relative value plays. The caveat here is that China growth stability achieved. Any fears of hard-lending or aggressive easing could weaken CNY considerably and pull the rug from under rest of AxJ FX.

USD Strength Driven by Fears of Faster Pace of Normalisation…

We thought it may be interesting to look back in 2021 to see how shifts in Fed guidance played a key role in USD's rise. In particular, **Fed's surprise hawkish tilt at its 16 - 17 Jun 2021 FoMC marked an important turning point for Fed policy and the USD** as the dots plot pointed to 2 hikes for 2023. Even though dots plot median projection then showed no rate hike expectation for 2022, there were a few FoMC members that indicated their preference for rate increases in 2022. It was also this very meeting that Fed Chair Powell first spoke about Fed tapering (recall the famous words, "you can think of this meeting that we had as the "talking about talking about" Fed tapering meeting).

Fig 1: DXY Strength Rode on Momentum following Fed's Hawkish Tilts Since Jun-2021 FoMC



Source: Bloomberg, Maybank FX Research & Strategy

Subsequently at the Sep-2021 FoMC, the Fed surprised again in saying that the Fed tapering process could be completed by mid-2022. The much shorter time frame (vs. 2014 tapering episode) suggested that Fed policy normalisation was beginning to look less gradual than previously anticipated. The **dots plot then also shifted hawkish with 1 hike pencilled in for 2022** (vs. none in Jun projection) and 3 hikes pencilled for 2023 (vs. 2 hikes in Jun projection) and also for 2024. The USD further strengthened amid fears of faster pace of policy normalisation.

At the recent 15-16 Dec 2021 FoMC, Fed again shifted more hawkish as **dots plot pointed to 3 hikes for 2022** (up from 1 hike in Sep projection) while the Fed also confirmed speculation for a **quicker pace of tapering** (which had begun in Nov) to conclude by Mar-2022 instead of mid-year 2022. It was also at this meeting that **Fed Chair Powell indicated that debate on when to start shrinking Fed's balance sheet (or quantitative tightening) was already underway** though there was no decision on when the run-off would start. While the USD did strengthen into Dec FoMC, it subsequently eased lower into end-year, in line with our call (see here for note) as we highlighted stretched USD long positioning (at 2-year high) may already have priced in rate hike expectations and US data strength.

Since start of 2022, USD has traded in choppy fashion, with bouts of USD softness in early-Jan as omicron variant though more infectious is perceived as less deadly (than delta variant), resilient RMB helping to anchor AXJ resilience while Powell's comments at senate confirmation hearing (11 Jan) somewhat helped to soothe sentiments - he framed the case for **policy normalisation in the context of shifting away from pandemic-driven monetary policy instead of a shift into restrictive stance** to curb an over-heating economy.

But USD bulls soon took over from 13 Jan, reflecting fears of even faster pace of Fed policy normalisation, rapid omicron spread affecting medical capacity in some countries such as US, UK while covid-related restrictions tightened for some jurisdictions such as HK, China, disappointing earnings guidance for US corporates as well as deepening tensions over Russia-Ukraine (Biden's threat to respond if Russia invades Ukraine). The Dec FoMC minutes and subsequent FoMC (27 Jan) **suggests a strong sense of urgency at the Fed on policy normalisation as inflation is running much higher than what Fed officials have earlier anticipated** while labour market conditions are largely consistent with Fed's goals. As such, **markets reacted to price in the scenario of Fed front-loading rate hikes following Fed's pivot away from supporting growth to focus on arresting inflation** (Dec CPI was 7%).

Fig 2: Rate Hike Premium Built Up in the Front End Since Dec-2021 FoMC

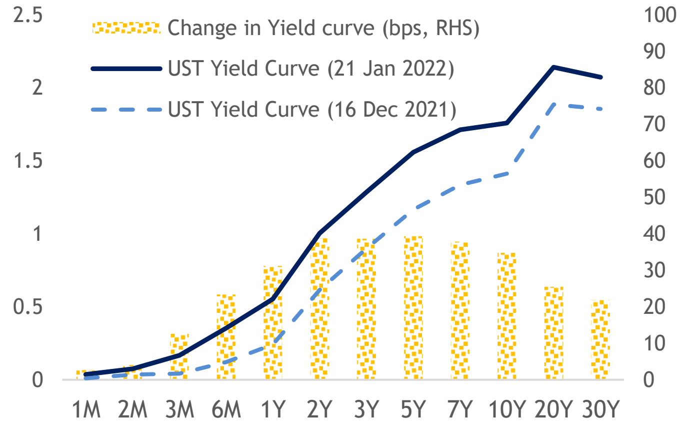
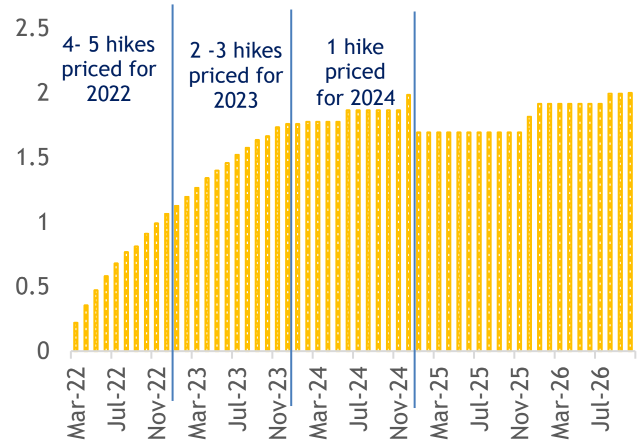


Fig 3: Markets (30d Fed fund futures) Now Pricing in 4 - 5 Rate Hikes for 2022 vs. Fed's Guidance for 3 Hikes



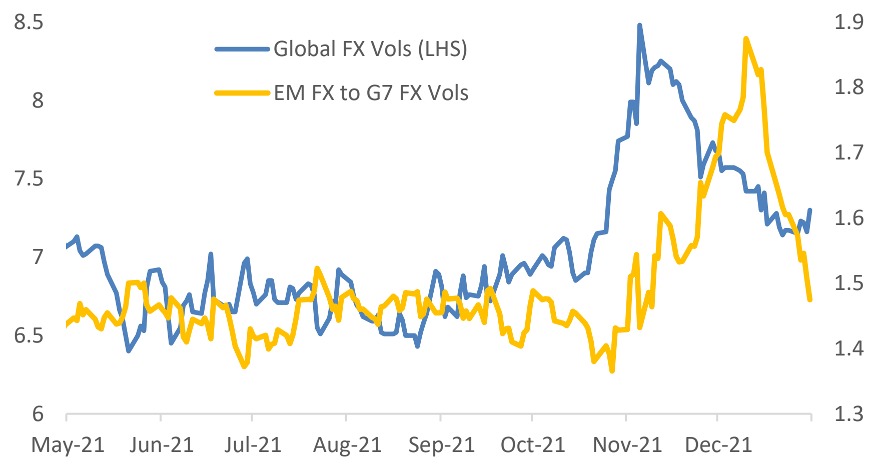
Source: Bloomberg, Maybank FX Research & Strategy

At the last FoMC (27 Jan), Fed leaned more hawkish with faster pace of tightening now a base case scenario as Fed now sees "risk that high inflation will be prolonged". In not pushing back markets' pricing for 4 hikes this year, it is likely that one can expect **Fed's dot plot to shift hawkish again at Mar FoMC** (current guidance as of Dec was for 3 hikes in 2022).

As of 27 Jan, 30d Fed fund futures are pricing in about 4 – 5 hikes for 2022 (vs. 3 hikes as per Fed's dots plot in Dec-2021) while a 25bps hike as early as at Mar FoMC is more than priced. There are also chatters of 50bps hike in Mar as Fed may need to do more to restore inflation-fighting credibility. Powell also took the opportunity to lay the roadmap for balance sheet normalisation – Fed to begin shrinking balance sheet after rate increases commence. Decision on timing and pace of balance sheet reduction will be made at coming meetings. He did point to the use of redemption caps to roll off balance sheet (like in 2017-19) instead of selling its holdings outright (to stem earlier speculation that Fed may consider this option).

With USD trading choppy, it is no surprise we see a rise in FX volatility. However, it was observed that **while volatility picked up for G7 FX, EM FX volatility fell**. We believe RMB's resilience (levels near 4y high vs. USD), improvement in covid situation in the region (vaccination picking up pace and daily infections easing lower), reopening optimism and sound macro fundamentals play a part in anchoring AXJ FX stability. We will explore this in other sections of the report.

Fig 4: EM FX Volatility Diverged from G7 Vols… In a Good Way



Source: Bloomberg, Maybank FX Research & Strategy

Quantitative Tightening - Does It Matter As Much?

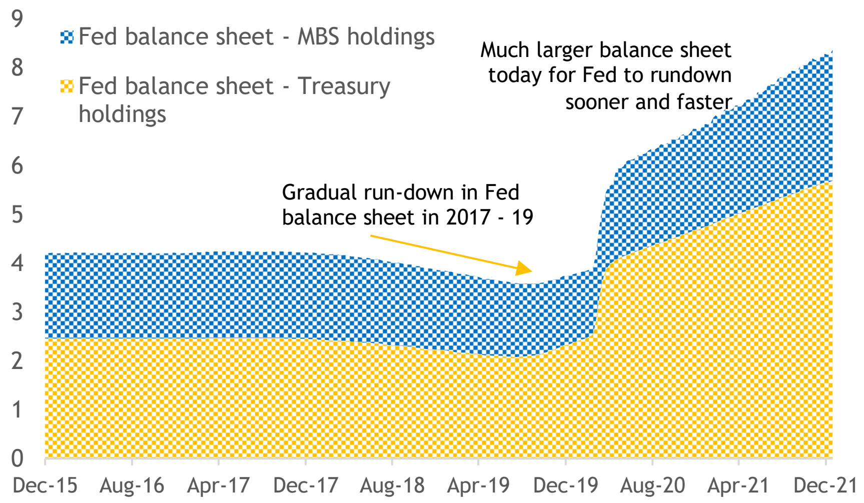
Recent Fed speaks and FoMC have garnered quite a bit of attention. First, the FoMC minutes (released 6 Jan) revealed that **officials are potentially contemplating with a faster pace of policy rate normalisation** given the speed of economic recovery as it also stressed on the importance of being flexible. Second, the minutes also showed there was **broad support for Fed to begin reducing the size of its balance sheet** (otherwise referred as quantitative tightening or QT) **after the first interest rate increase with some officials saying that such a move could happen "relatively soon"**. Third, Governor Christopher Waller's interview on Bloomberg TV (13 Jan) touched on **shrinking balance sheet by summer** (typically Jun - Sep for US). And this reconciles with Fed Chair Powell's earlier comments made at the senate confirmation hearing (11 Jan) that Fed will begin to shrink its $8.8tn balance sheet later this year. He noted that **Fed officials will likely move sooner and faster this time when reducing balance sheet** than it has during 2017 – 19 episode. Though no decision has been made, Powell said that debate in ongoing and it could take "two, three or four meetings" for them to come to a decision.

Piecing these anecdotal comments together, we opined that the 4th May 2022 FoMC (4th Fed meeting if Dec-2021 was the 1st meeting the Fed officially debated on QT) may see Fed preparing markets for balance sheet run-off and 15th Jun FoMC or the 3rd quarter-2022 may likely be the start of QT.

Concerns arise if Fed's double tightening - rate hikes (possibly starting in Mar) and balance sheet run-off (likely in 3Q) - will drive an extended sell-off in bonds and equities (which has already happened) and see risk-off sentiment driving the USD higher.

This scenario of **double tightening in quick succession is unprecedented. Uncertainty on this front may temporarily lend support to the USD**. The last time Fed conducted QT in 2017 – 19 was much more gradual and careful. QT only came 2 years after rate normalisation was well underway, that is after the Fed has raised interest rate 4 times (to 1% - 1.25% from 2015 lift-off). And the QT process was gentler with monthly run-off starting at a pace of $10bn/month ($6bn in USTs and $4bn in MBS) and slowly rising by $10bn/month every 3 months to peak pace of $50bn/month ($30bn in USTs and $20bn in MBS) a year later. In total, about $650bn was rolled off Fed's balance sheet as QT abruptly ended in Sep-2019 after the onset of US repo crisis.

Fig 5: QT to come Sooner and Faster than in 2017-19 Episode



Source: Bloomberg, Maybank FX Research & Strategy

This time round, rate normalisation hasn't even started and the Fed has begun to talk about reducing its balance sheet "sooner and faster". Fed's justification is that US economy is stronger, inflation much higher and balance sheet much larger (about twice the size) today than the last time it did QT. We opined that is a fair point however the process of reducing Fed's balance sheet (i.e. pace of reduction, stop reinvesting maturing securities or sell securities on its balance sheet, etc.) and Fed communication are critical to avoid a disorderly normalisation process that may unsettle financial markets or derail economic growth recovery.

- Based on Bloomberg News survey of Economists (14 – 19 Jan), the median estimate for monthly reduction is between $40bn and $59.9bn (vs. 2017-19's starting pace of $10bn/month); 29% of respondents look for run-off to commence from Apr – Jun while 40% expect Jul - Sep.

In sum, markets now have to deal with faster pace of policy normalisation as it moved away from an era of QE taper, gradual policy normalisation and inflation as transitory. Play up of QT uncertainties can undermine sentiments and add to USD strength in the interim but it remains early to over-react as balance sheet run-off has many parameters and considerations and the Fed has yet to decide on the plan. A run-off in line with expectations guided by the Fed may not be disruptive after all.

Recall the argument put forth by Fed's Bullard when quantitative tightening is not quantitative tightening, Mar-2019 (see here), that the ***financial and macroeconomic impact of Fed's balance sheet policy may well be asymmetric****. That is, the size of the balance sheet may have mattered while it was increasing but not while it has been decreasing. With the policy rate near zero, the effects of QE may have been substantial due to signaling effects. Now, with the policy rate well above zero, any signaling effects from balance sheet changes have dissipated. This means that balance sheet shrinkage, or QT, does not have equal and opposite effects from QE. Indeed, one may view the effects of unwinding the balance sheet as relatively minor*.

Subsequently in another essay (see here) by St. Louis Fed Vice President Christopher Neely, he wrote that studies indicated that 2008-13 QE and forward guidance jointly reduced 10y UST yield by 100 to 200bps but QT is unlikely to significantly impede economic activity. He explained that *"most of the yield reductions from Fed unconventional policies are probably already undone; some will not be reversed (i.e., yield changes from the reintroduction of liquidity in bond markets); and the remaining effects will probably disappear gradually, over the course of many years. As a result, quantitative tightening will probably not affect the economy in any noticeable way."*

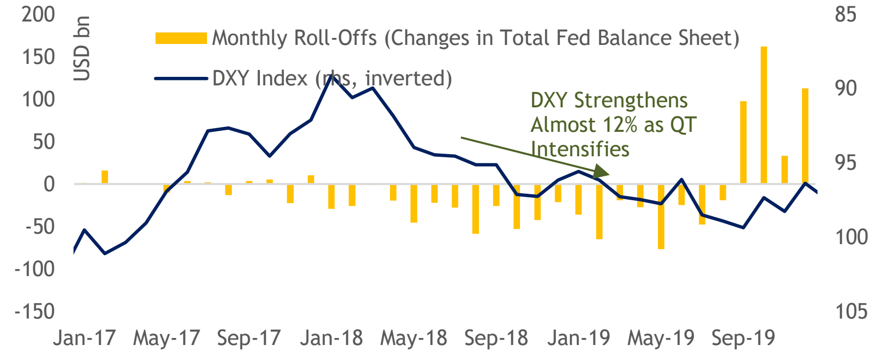
In an earlier research by Kansas Fed in May 2017 (see here), it was estimated that a $675bn reduction in Fed's balance sheet over a 2-year horizon is about equivalent to a 25bps hike in Fed fund rate.

As much as Fed researchers argued that the impact from QT may not matter as much as QE, we opined the scenario of **simultaneous tightening of rates and balance sheet run-off could see both front and longer-term rates go higher in tandem**. To add, a rapid (instead of gradual) run-down of the Fed's balance sheet may act to further support longer-term yields. To some extent, this may help to avoid the flattening of the yield curve as longer-term yields stay supported. Yield curve flattening or inverting tends to be viewed as a classic leading indicator that economic recession is likely in coming quarters (UST 2y10y yield curve has inverted before each recession in the last 50 years except on one occasion in 1998. At the same time, a steeper yield curve should also help to preserve margins for lenders.

QT and the USD Strength 2017-2019 (More than Meets the Eye)

History typically provides some guidance for future actions. We take reference from the last episode of quantitative tightening to have a gauge of market impact. Fed started quantitative tightening in Oct 2017, almost two years after the first rate hike in 2015. The pace of balance sheet roll-off then was kept gradual by limiting the amount of bonds allowed to mature. The roll-off was scheduled to start with a cap of $6bn/mth for Treasury securities, $4bn/mth for agency debt and mortgage-backed securities (as stated in the *Addendum to the Policy Normalization Principles and Plans*). Caps are then raised in three-month intervals until respective caps are at $30bn and $20bn per month respectively. **As the balance sheet roll-off started to gather pace, the DXY index was also observed to appreciate and gained almost 12% over this period.** We note the absence of USD strength at the start, possibly due to ample assurance by the Fed that roll-offs would gradual.

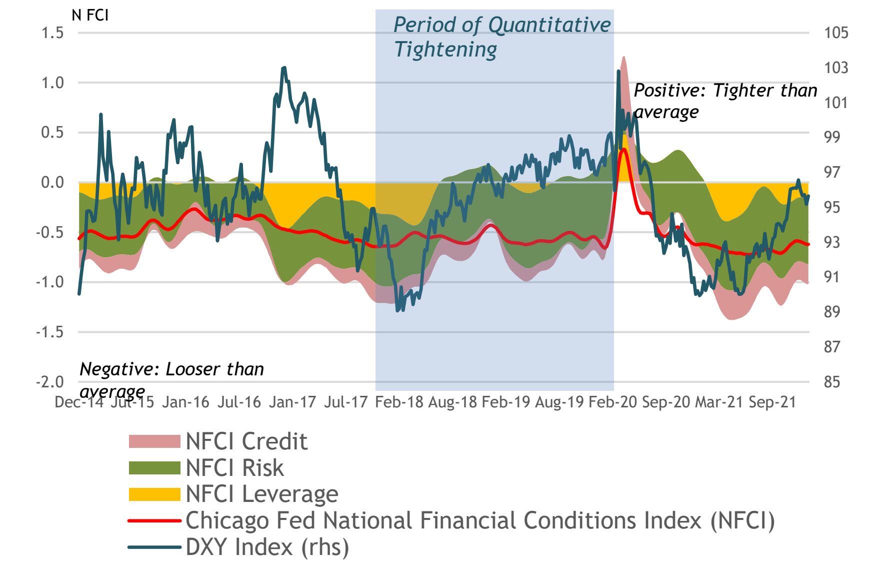
Fig 6: QT Coincided With Significant USD Strength



Source: Federal Reserve, Bloomberg, Maybank FX Research & Strategy

The coincidence of QT and 2018-2019 USD strength likely provided some underpinnings for the greenback in the past few months amid concerns of tightening financial conditions, not least exacerbated by the expectation for double tightening in quick succession that did not occur the last round.

Fig 7: QT Did Not Tighten Financial Conditions Much



Note: Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

Source: *Federal Reserve Bank of Chicago, Chicago Fed National Financial Conditions, retrieved from Federal Reserve Bank of St. Louis, Bloomberg* (25 Jan 2022)

However, a check on the 2017-2019 QT episode revealed that financial conditions were hardly affected by the reduction of balance sheet for much of the two years. Fed's overall national financial condition index (red line) was rather flat during the period. This could mean that QT may not have been the key driver of USD strength afterall.

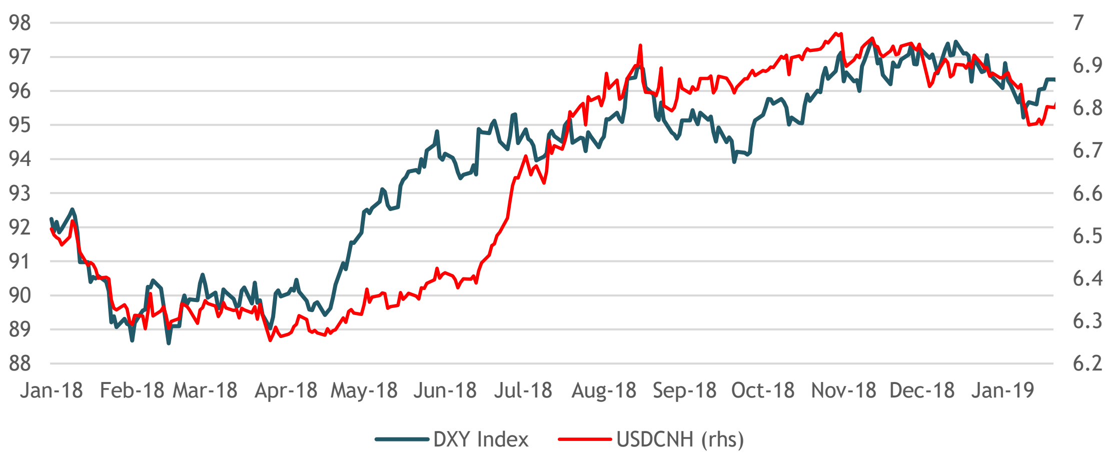
US-China Trade War

It is likely that there could be another major driver of USD during that period and we could think of none other than the 2018 US-China trade war. The first significant event was the Section 301 probe launched by former US President Trump on 14 Aug 2017 into possible Chinese intellectual property theft. The USD started to rise more meaningfully after Apr 2018 when both the US and China imposed tariffs of up to 25% on $50bn of imports from each other. USD appreciation gained momentum after Trump threatens tariff on another $200bn of Chinese imports thereafter. As illustrated by the charts below, USD started to soften when a deal was in sight.

Fig 8: US-China Trade War Tracker

Source: *MBB RMB Watch 2019, Bloomberg, Various News Sources*

Fig 9: USD Strength Was Fanned By Trade-War Driven Safe Haven Demand



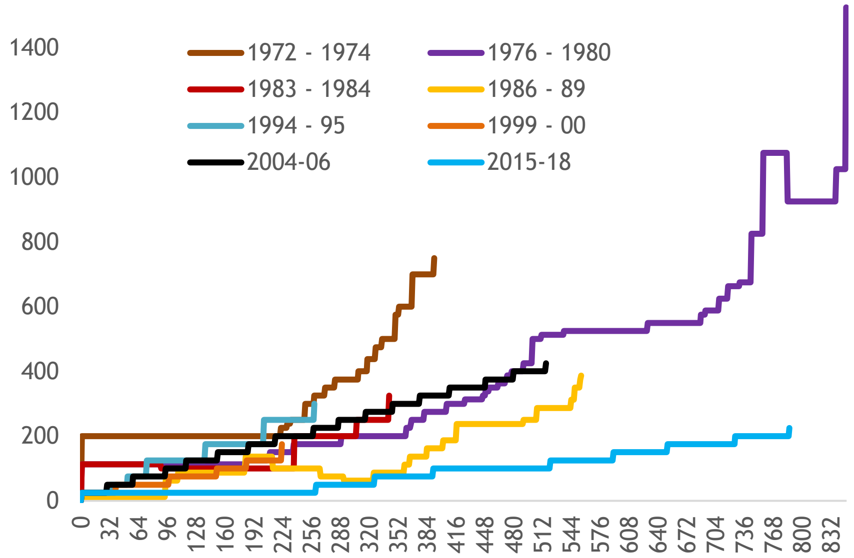
Source: Bloomberg, Maybank FX Research & Strategy

Taken together, we see possibility that quantitative tightening may not severely tighten the overall financial conditions in the US and provide lasting boost to the USD bulls.

Fed Rate Hikes May Not Result in USD Strength

In the last 50 years, there were 8 cycles of Fed rate hikes and they differ in trajectory, length of tightening and even the pace of each incremental hike. Fed rate hike cycles in the 1970s lasted longer in length with the pace of tightening much quicker and peak rate much higher than cycles post-1980s. Over time, rate hike cycles post-1990s were less steep and peak rate much lower than in 1970s and 1980s.

Fig 10: Fed Hike Cycles Milder in Trajectory Over Time



Source: Bloomberg, Maybank FX Research & Strategy

Of interest, the 1976 cycle was one of the longest seen in the last 50 years and lasted nearly 40 months with fed fund rate rising by 1525bps to as high as 20% in 1980 as Fed fought double digit inflation then.

The last rate hike cycle which started in 2015 was the second longest in the last 50 years as Fed took 36 months but in contrast to 1976 cycle, the path of normalisation was very gradual and the peak rate was much lower. Cumulatively, Fed raised rates by 225bps to as high as 2.5% in 2018.

This time round, **more hikes are expected to be frontloaded** before the pace tapers off in following years. Based on OIS positioning (as of 24 Jan 2022), markets expect 4 hikes in 2022, 3 hikes for 2023 and 1 hike for 2024. The sequence is unlike the 2015 episode when rates hikes started slow but picked up pace towards end-cycle.

If history is any guide, we looked back at DXY performance in each of the last Fed hike cycle over the past 50 years or so. The first few days post-first fed rate hike may see DXY appreciate by about 1% but this was only applicable to recent 4 cycles since 1990s. A better read to weed out noise may be to look at DXY movement over a slightly longer time window, say T+90 trading days. With the exception of 1983 - 85 Fed hike episode, **dollar generally decline post-first fed rate hike in T+90 trading days window.** This is akin to the old adage of *buy the rumor, sell the fact* as market anticipation for Fed hike has already been expressed in USD long positioning (thanks to guidance from the Fed) and this also explained how the **USD typically strengthen in the lead-up to event risks, including Fed tightening**.

Fig 11: DXY Typically Fall Post-First Fed Rate Hike

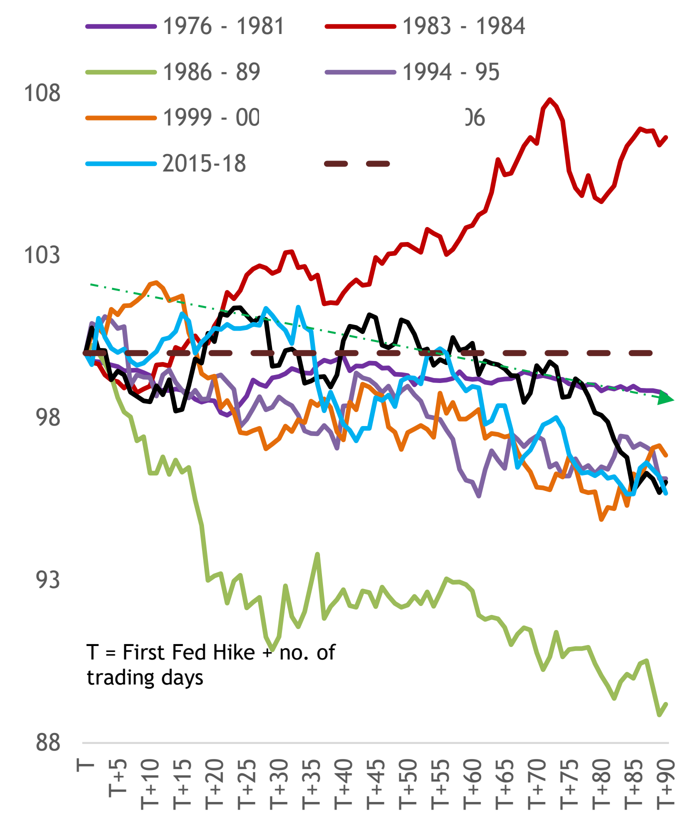
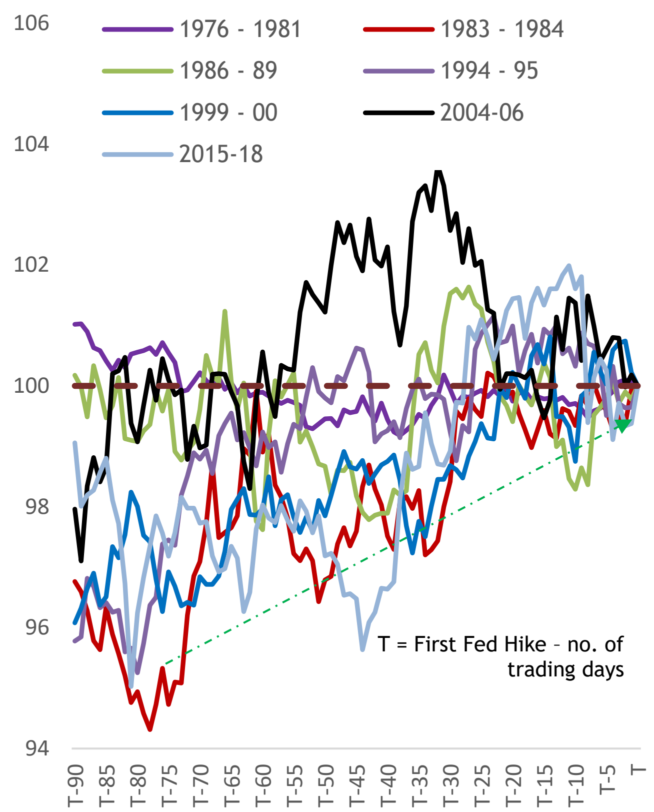


Fig 12: But the Lead-up to Fed Tightening Typically See DXY Strengthens



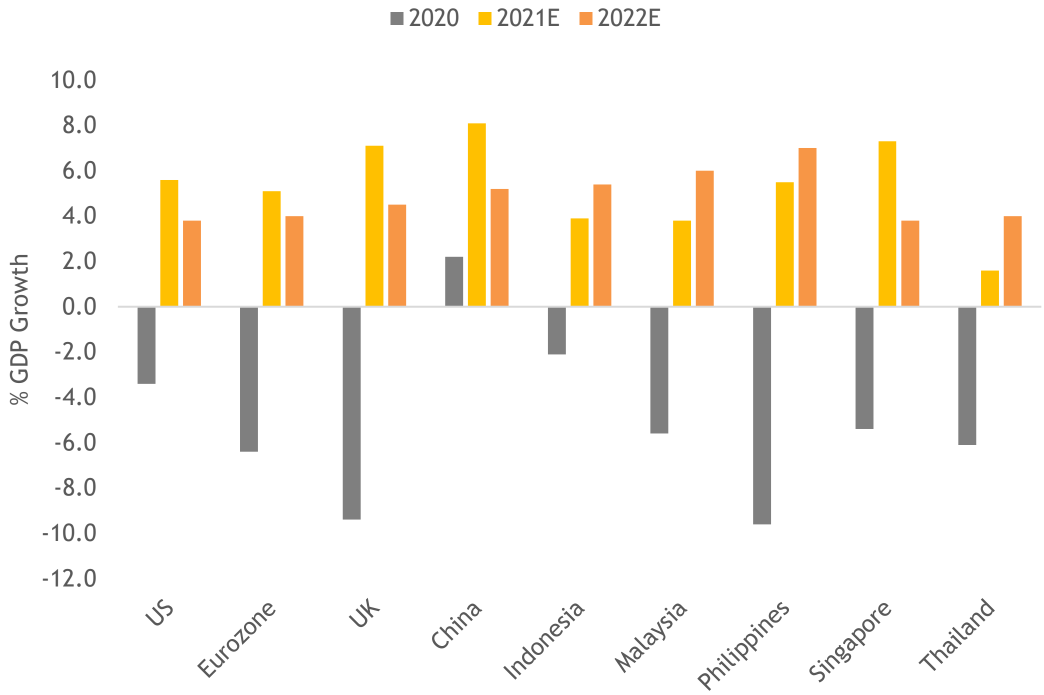
Source: Bloomberg, Maybank FX Research & Strategy

ASEAN "Catch-Up" Growth, Monetary Policy Tightening to Begin

One notable aspect regarding global growth trends in 2022 is that markets mostly expect large economies such as US, Europe and China to moderate from their 2021-highs. Despite some see-sawing in Covid restrictions, most of these economies had arguably benefitted from early access to vaccines and sustained stretches of reopening-type policies in the past year, with low-base effects in 2020 further boosting GDP growth readings in 2021.

In contrast, for most of ASEAN, vaccines only became more widely available in 2H 2021, and periods of intermittent, severe lockdowns throughout the year weighed on growth discernibly. In some sense, interim Omicron drags aside, most of ASEAN should see a modest rebound in growth momentum this year, with higher vaccination rates and Covid-endemic policies helping to buffer economic health from swings in Covid case trajectories.

Fig 13: Likely Convergence in Growth Pace into 2022, with ASEAN Rebound

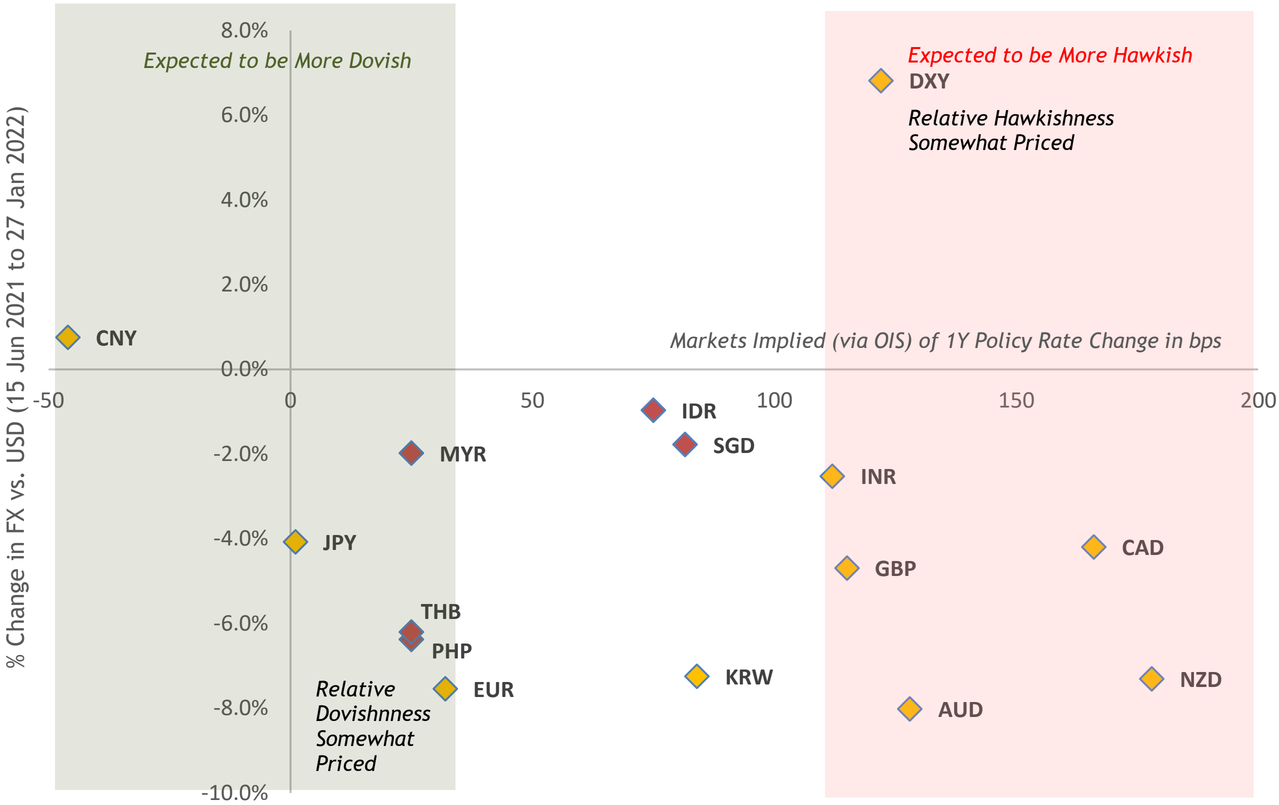


Note: Projections for US, Eurozone, UK and China are extracted from Bloomberg on 25 Jan, while that for ASEAN-5 are Maybank IBG house views.
Source: Bloomberg, Maybank IBG Research, Maybank FX Research & Strategy

This "catch-up" provides a foundation of more robust macro fundamentals from which some Asian central banks can begin to contemplate withdrawal of earlier monetary policy stimulus. **In a broad sense, less-divergent policy paths between some regional central banks and the Fed could mean lower likelihood of outsized drags on AxJ FX despite Fed tightening concerns**.

In any case, extent of broad volatility spillovers from higher UST yields to Asian assets could be contained versus earlier Fed tapering episodes, given relatively lower dependence on foreign capital, larger FX reserves, resilient current account dynamics, firmer macro fundamentals. (Refer to *ASEAN Macro 2022 Year Ahead: The Endemic New Normal* report published on 4 Dec 2021 for a broad discussion.)

Fig 14: Likely Earlier Policy Normalization in SG, ID; TH and PH Possible Policy Laggards But Somewhat Priced



Note: For ASEAN economies (red diamonds), house view of policy rate moves is used, with exception of SG where monetary policy tool is exchange rate. Markets implied (via OIS) of 1Y policy rate change extracted from Bloomberg on 27 Jan for non-ASEAN economies (yellow diamonds).
Source: Bloomberg, Maybank IBG Research, Maybank FX Research & Strategy

On the chart, relative hawkishness or dovishness of each economy's monetary policy is charted on the x-axis in terms of expected 1Y policy rate changes, while the y-axis records each currency's change since mid-June 2021, arguably the pivotal month when Fed started leaning hawkish and concerns over convergence/divergence in global monetary policy began.

In the top-right, we have the dollar DXY. Markets are pricing in 4-5 rate hikes from the Fed this year and DXY has also gained by about 7% since June 2021, i.e., relative hawkishness has arguably been somewhat priced. In the bottom left, we have EUR, THB, PHP. Expectations are for the ECB, BoT and BSP to be relatively more cautious in their pace of policy normalization going forward, but significant losses over the past half-year have likely factored this in to a large extent as well.

For DMs, FX with relatively more hawkish central bank policy outlooks (NZD, CAD, AUD, GBP) could potentially receive greater support from monetary policy moves this year, versus peers. Meanwhile, for ASEAN, we attempt to go through the key monetary policy nuances in greater detail below.

For IDR, house view looks for BI to start hiking in 2Q, delivering 3 hikes (+75bps) to bring policy rate to 4.25% at end 2022. Pre-emptive signalling of stimulus withdrawal is underway, with start of reserve ratio hike.

- BI kept its policy rate unchanged on 20 Jan, but hinted at start of stimulus withdrawal with the announcement of a reserve ratio hike to 5% (from 3.5%) starting 1 March. Governor Perry Warjiyo highlighted that any unwinding of monetary policy stimulus will be gradual, starting with reducing liquidity in the financial system before raising the policy rate.
- BI now expects the Fed to hike 4 times this year starting in March, a significantly more hawkish view of the Fed versus expectations late last year of only one Fed hike in 2022. Given this shift, as well as BI emphasis on IDR stability, it is likely that BI won't be too far behind in its rate normalization path relative to the Fed.

For SGD, expectations are for further policy tightening this year, including a potential re-centering move in Apr, possibly coupled with another slight slope-steepening move.

- MAS announced a surprise off-cycle decision on 25 Jan, raising "slightly" the slope of the SGD NEER band, while leaving the width and level at which it is centred unchanged. We estimate that the slope is now at 1.0% p.a., versus 0.5% prior. The decision is premised largely on rising inflation risks, with MAS citing "rapidly accumulating external and domestic cost pressures".
- The policy move should be largely seen as a reinforcement of the strategy that MAS has embarked on since last Oct, i.e., pre-emptively adjusting policy parameters in calibrated steps as assessment of inflation risks swing to the upside.
- Between now and April though, with our model suggesting that SGD NEER is currently near the upper bound of the band, there might be limited room for immediate SGD gains.

For MYR, review of monetary policy settings may have begun but central bank could be patient in embarking on rate hike. House view is for OPR to stay at current level before a +25bps hike in 4Q 2022, i.e., 2-3 Nov 2022, followed by +50bps hikes in 2023.

- BNM kept OPR unchanged at 1.75% as expected in its Jan meeting and there was no surprise in the MPC statement. Our economist team opined that MPS remained "neutral" as the positives of continued global economic recovery and the domestic economy's rebound last quarter which is expected to gain momentum this year is still tempered by the risks to growth remaining tilted to the downside (e.g., weaker-than-expected global growth; worsening in supply chain disruptions; emergence of severe and vaccine-resistant COVID-19 variants of concern).
- The team also highlighted the removal of the line "committed to utilise its policy levers to foster enabling conditions for a sustainable economic recovery" from MPS, which could suggest that while current monetary policy stance is appropriate and accommodative, BNM has commenced review of various measures.
- With regards to Fed's policy normalisation cycle, our economist team thinks the pressure for BNM to react is mitigated by the absence of "2013 Taper Tantrum" like market impact.

For THB, our economist team expects a first policy hike from BoT in 3Q (to 0.75%) before another 2 hikes in 2023.

- Omicron and concomitant pushing out of tourism recovery could mean that monetary policy has to be kept relatively accommodative for now to support growth.
- But as global and regional central banks start to tighten monetary policy, BoT may have to follow (albeit at a more contained pace) given its weaker external balance as compared to pre-pandemic times. Our economist team expects the current account to stay in a mild deficit in 2022, significantly lower versus the 7% of GDP surplus in 2019.
- 2H 2022 could see clearer signs of turnaround in the economy as tourism gradually recovers and consumer confidence improves.

For PHP, with inflation being mainly supply-side driven and cost-push rather than demand-fuelled and wage-pull, house view looks for BSP to raise the policy interest rate by +25bps in 4Q 2022, before another +50bps in 2023.

- Expectations are for the easing trend in monthly headline inflation to continue—supported by government measures to ensure sufficient domestic food supply and partly due to the base effect from the higher inflation in 2021. This could take some pressure off BSP to normalize policy soon.
- Given the recent Covid surge and likely see-saw in restrictions, negative (on average) real interest rates for the year may still be needed to support growth.
- One key risk to monitor would be commodity prices, given Philippines' net energy importer status. Accordingly, any large positive shocks to imported energy prices could lead to an earlier-than-expected policy normalization schedule. IMF recently commented that BSP should be prepared to act against "more entrenched" inflation or a possible capital outflow in the event of faster tightening by the US Fed.

To summarize, from a monetary policy convergence/divergence perspective, given likely greater patience from BNM, BoT and BSP in raising rates, relative drags has likely spilled over to MYR, THB, PHP sentiments in recent months. But deeper losses for THB, PHP in recent quarters could mean that this dynamic has been priced in somewhat.

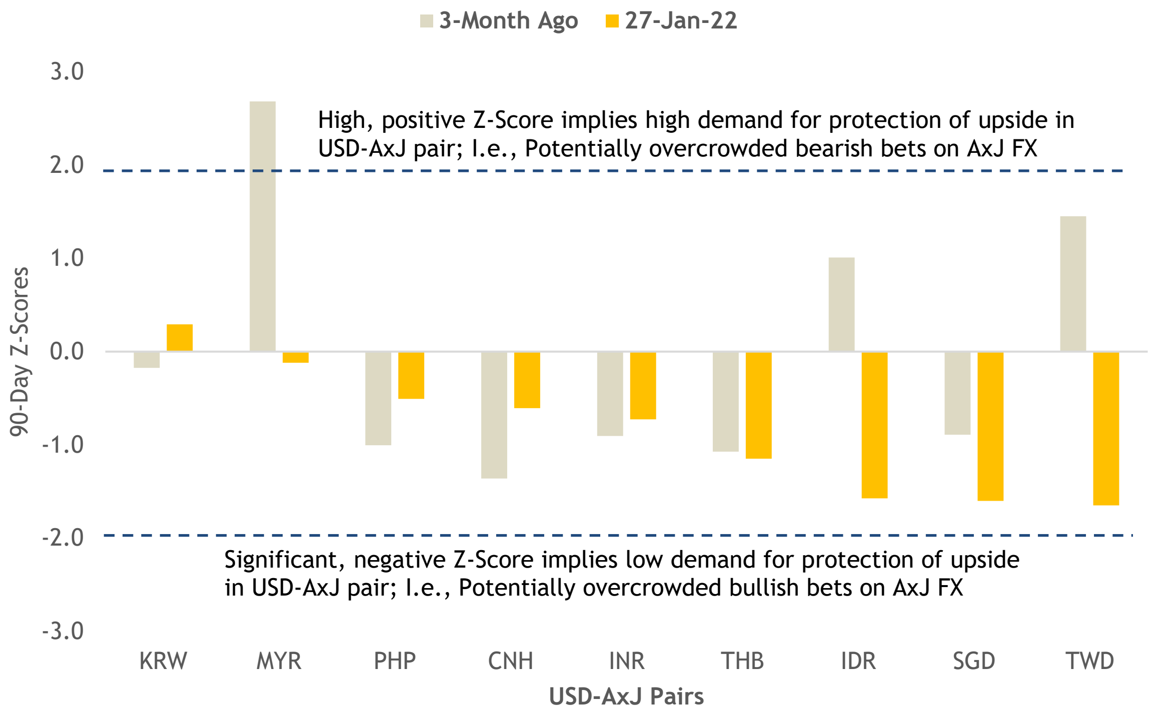
For MYR, the relatively modest weakness versus USD recorded in the last half-year is not commensurate with expectations for diverging policy biases between Fed and BNM. One likely reason for still-resilient MYR performance could be that the >20% rally in brent prices since mid-Jun 2021 has offset such MYR drags in a significant manner. This means that any bouts of downswings in oil prices, e.g., faster-than-expected recovery in global inventories, should be monitored more closely for possible loss of support in MYR. Outlook for oil still largely benign, with house view of brent prices averaging US$75-80 in 2022.

For SGD, more room for gains is seen from 2Q, especially given house view for a potential re-centering move (higher) in Apr, possibly coupled with another slight slope-steepening. Immediate gains in 1Q should be capped with SGD NEER trading near the upper bound of the policy band.

For IDR, policy-makers are mindful of policy gaps with the Fed and will likely act in tandem to some extent. Some convergence with Fed policy path over the course of the year could be supportive of IDR.

Flows and Positioning

Fig 15: Markets have Broadly Turned Bullish on AxJ FX against the USD, Versus 3 Months Ago



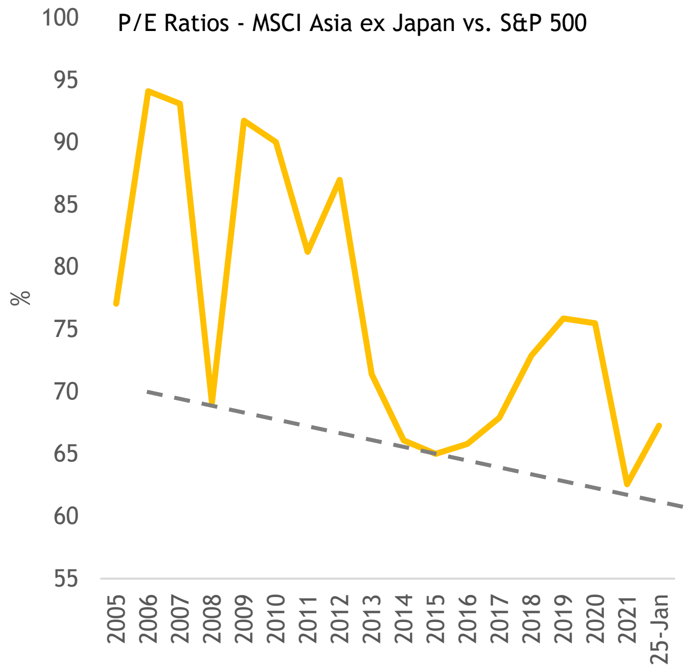
Source: Bloomberg, Maybank FX Research & Strategy

We also attempt to gauge the positioning of Asian FX against the USD using volatility-adjusted risk reversals (i.e., the delta-neutral difference between call-option and put-option volatilities). The chart shows the 90-day Z-scores of the risk reversals for easy interpretation, with any value near or larger than +2 implying potentially overcrowded bearish bets on AxJ FX and any value near or lower than -2 implying potentially overcrowded bullish bets.

Broadly, markets require significantly less protection against AxJ FX losses against USD, versus conditions three months ago (i.e., yellow bars smaller or more negative versus grey bars). This suggests that large dollar surges are viewed as less likely now, and possibly also reflects a more cautiously optimistic mood in Asia as Covid risks have yet to weigh on growth momentum excessively.

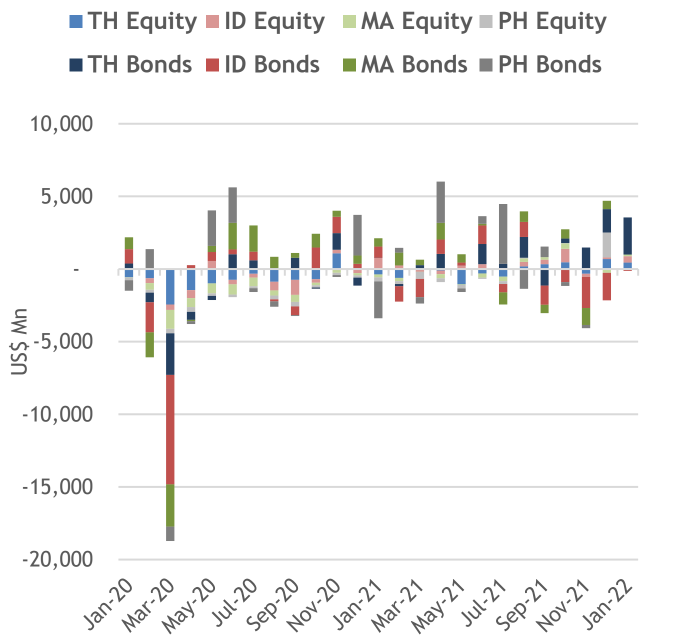
In particular, positioning in MYR (versus USD) has turned from stretched bearish three months ago, to about neutral now. A note of caution on IDR, TWD and SGD longs, with bullish bets near to stretched conditions.

Fig 16: Asian Equity Valuations (relative to US) Could Have Hit Interim Trough



Source: Bloomberg, Maybank FX Research & Strategy

Fig 17: Recent Portfolio Flows to ASEAN Countries Not Significantly Impacted by Fed Signals



Note: Jan 2022 data are MTD as of 25 Jan. Bond flow data for MA, PH available till Dec, Nov 2021, respectively.
Source: Bloomberg, Maybank FX Research & Strategy

With valuations for Asian equities reaching relative lows versus US assets in end-2021, risk-reward dynamics suggest some chance for potential recovery in regional equity inflows in 2022. P/E ratios as per late Jan do suggest some relative appeal of Asian assets gaining traction.

Notably, while regional bourses are not spared from recent jitters over Fed normalization concerns (treasury yield spike in early Jan) and Russia-Ukraine tensions, outflow risks have been relatively contained. For instance, outflows from Indo bonds (red bars) eased into Jan, and is largely negligible MTD. Thai, Indo and Malaysian equities are also seeing net positive inflows MTD as of 25 Jan.

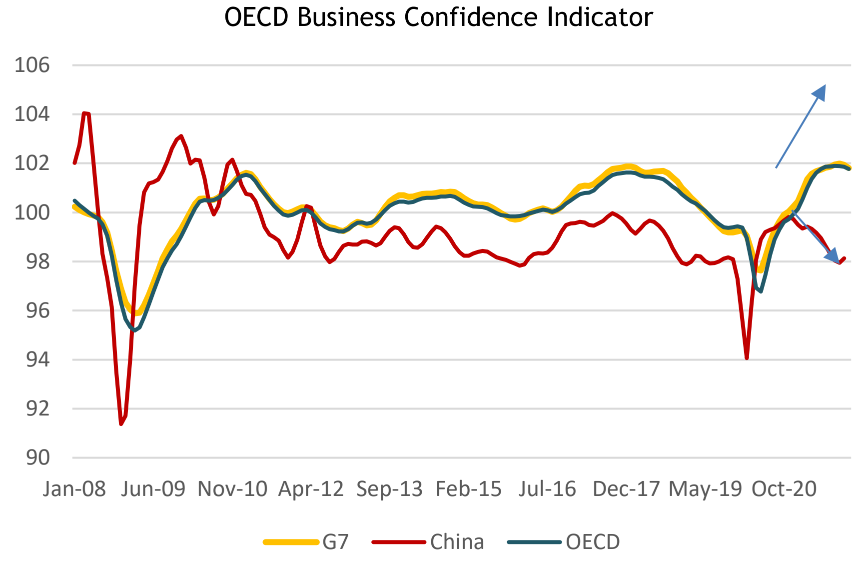
Even in the case of more severe bouts of negative turn in sentiments, lower foreign holdings in various asset classes regionally could also mitigate the extent of outflows and FX drags. For instance, foreign holdings in Malaysian equities have declined to around 20.4% as of end-2021, compared to decade-high of 25.2% in 2013. Foreign holdings in Indo local currency government bonds have also been on a decline in recent years, halving from around 40% in mid-2019 to 19% in end-2021. That for Thai local currency government bonds has also fallen, albeit on a gentler decline from around 18% in mid-2019 to 14% in end-2021.

Going forward, Omicron drags are largely expected to ease from 2Q, and allow further regional reopening plans to progress. A more discernible tilt towards pro-growth policies in China (see next section) could be supportive of overall regional sentiments as well. These dynamics should be supportive of AxJ FX, once the worst of Fed tightening fears passes.

PBoC - The Outlier (What It Means for AxJ)

A combination of regulatory tightening, zero Covid tolerance pandemic strategy and some extent of monetary policy tightening alongside supply shocks had weakened China's domestic demand significantly in 2021. China is thus on a different business cycle compared with peers. This results in concomitantly divergent path for PBoC versus most other central banks as well.

Fig 18: Business Confidence in China Could Be Near a Trough While G7 and Others Peak



Source: OECD, Maybank FX Research & Strategy

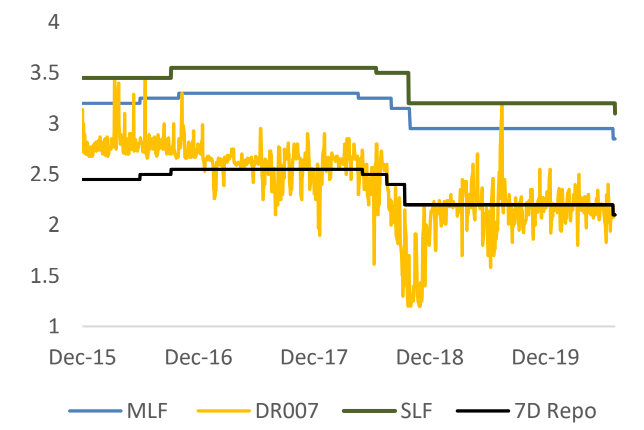
The Chinese government has reiterated pledges to support growth recently and started the year with a series of monetary policy accommodation. These actions along with other fiscal/administrative measures are growth boosters (fee cuts, tax cuts, etc) and indicate a more decisive shift towards prioritizing growth vs 2021. Apart from the current downside economic pressures, there is a Communist Party Congress at the end of the year (4Q) that could see President Xi seek an unprecedented third term. Such significant political event could typically warrant a picture of stable macro backdrop. The political event suggests that there is a limited window for the government to achieve growth stability within the first half of 2022.

Easing In A Hurry

On 17 Jan, PBoC cut 1Y medium-term lending facility (MLF) and 7-day reverse repo rate by 10bps right before a set of mostly weaker Dec activity data (including 4Q GDP) was released. Loan prime rates were lowered on 20 Jan - 1Y LPR dropped 10bps to 3.70% and 5Y LPR fell 5bps to 4.60%. Apart from deploying moral suasion to ensure lower loan prime rates, banks are also encouraged by the central bank to increase lending. On Fri (21 Jan), PBoC also announced that the Standing Lending Facility rates have been also lowered by 10bps from 17 Jan, effectively completing the move of taking the full interest rate corridor lower. The 14-day reverse repo was lowered by a congruent 10bps as well on 24 Jan.

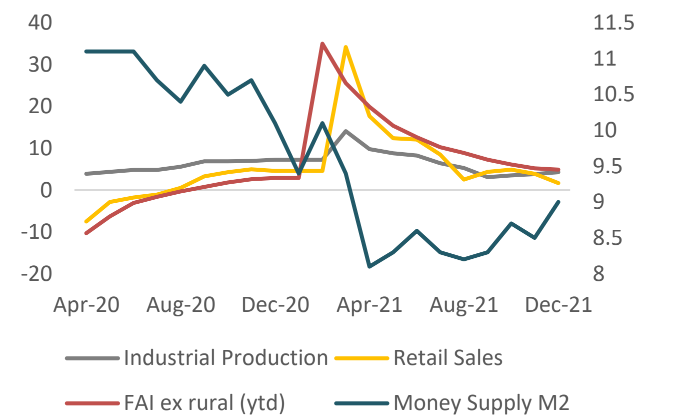
PBoC is unlikely to stop easing here. On 18 Jan, Deputy Governor Liu Guoqiang mentioned about the possibility of another RRR cut even as room for it has become smaller (China's reserve required ratio is not much higher than those of peers). He also pledged to "open the policy tool box wider" to support growth, "maintain money supply" and to prevent a collapse in credit.

Fig 19: China's Interest Rate Corridor Lowered..



Source: PBoC, Bloomberg, Maybank FX Research & Strategy

Fig 20: .. To Provide Greater Support to the Economy



Source: National Bureau of Statistics, Maybank FX Research & Strategy

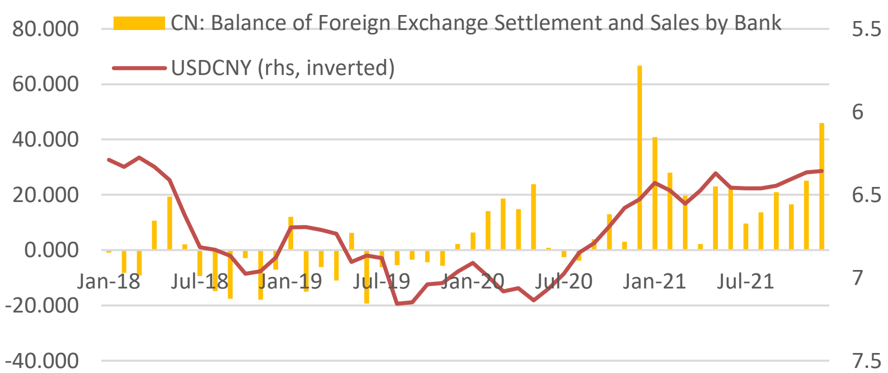
USDCNY Reaction to Rate Cut was Subdued

The 10bps cut for MLF rate and 7-day reverse repo rate were perceived to be larger than expected. Market watchers were guided by the 5bps decline in the 1Y loan prime rate (LPR) in Dec. Since the rate cuts (MLF, 7, 14-day reverse repo, LPRs), USDCNY has slipped further, seemingly contrary to expectations. Rate cuts are expected to be negative for RMB given that it has benefitted substantially from carry trades and narrowing yield differential should in fact see some unwinding of the long CNY position. Clearly, carry is just one of the underpinning factors of the CNY which we have mentioned before.

CNY's Initial Gains on Easing Actions - Why?

Apart from carry advantage, the CNY has been propped up by strong export receipts. These export receipts translate to substantial selling of foreign exchange and concomitant demand for CNY. As a result, the net foreign exchange settlement has been in persistent surplus during the pandemic, indicating strong corporate demand for the local currency.

Fig 21: Foreign Settlement surplus, Backed by Strong Trade Bal Lift CNY



Source: State Administration of Foreign Exchange, Bloomberg, Maybank FX Research & Strategy

China equities have also been affected by a series of regulatory tightening over 2021. However, the recent shift towards growth supports and fewer regulatory announcements have seen Chinese equities starting to recover relative to foreign counterparts as seen in the next chart of MSCI China vs. MSCI US. Fresh interests in perceived undervalued Chinese equities also increase the allure of the currency at this point.

We look for CNY to retain much of its underpinnings including (1) strong current account surplus, (2) passive-investor bond-related flows due to WGBI inclusion along with (3) renewed interest in local equities as China unleash various growth boosters.

Apart from supports from portfolio and current account surplus, the policy easing action also show a stronger commitment towards growth stability and that is taken to be RMB-positive in a world where some developed nations are near peak growth but this euphoria from the easing signal may fade eventually.

In a world where more countries have started to embrace "living with Covid" and barring unexpectedly lethal variants, demand recovery may be more apparent in the rest of the world especially within Asia where vaccination rates have caught up. As such, the outperformance of CNY should start to slow.

As policy divergence progress to a greater extent within the region, speculative demand for Chinese assets (especially bonds) should also weaken at some point (especially when PBoC is near the end of easing cycle) relative to regional peers where recovery is expected to be further along. That reinforces our negative bias on CNY on a trade weighted basis.

What Does it Mean For AxJ FX?

Greater monetary policy accommodation provided by PBoC should not be taken as an outright negative for Asian currencies as we look for growth stability in China to also translate to stronger demand for goods from the region.

Should Market Forces Turn Against the CNY…

Our base case scenario assumes that the current cross-cyclical policy strategy has worked and consumption, investment revived because the authorities are able to be more targeted in their lockdown reactions, consumption has become more resilient to restrictions and growth show signs of stabilization heading into 2H.

However, **a hard landing for China remains a tail risk**. With the Chinese authorities so unwilling to let go of zero-Covid policy and the three red lines for property developers, there is a chance that growth recovery could be slower than desired and PBoC is forced to ease monetary policy more aggressively. A runaway inflation in the US could even force Fed to be more aggressive in tightening. That could drastically narrow (or even invert) the US-CH yield differentials and at that point, fears of hard lending could dampen CNY sentiments further and spur the currency into a more dramatic tailspin.

Should market forces turn against the CNY, we can expect a USDCNY rally to pull the rug from under most AxJ FX.

Concluding Remarks… Opportunistic FX Plays

In light of heightened market volatility and policy winds of change with Fed sounding more hawkish at every FoMC since Jun-2021 and the PBoC cutting rates in Jan-2022, we see a handful of opportunistic FX proxy plays, on a relative bilateral basis and via basket trades.

Based on our findings and analysis from the report on Fed rate hike cycles, PBoC moves, central bank divergence, flows and positioning and technical indicators, some of these opportunistic plays can be strategic (beyond 3 months), tactical (up to 3 months) and technical (1 -2 weeks).

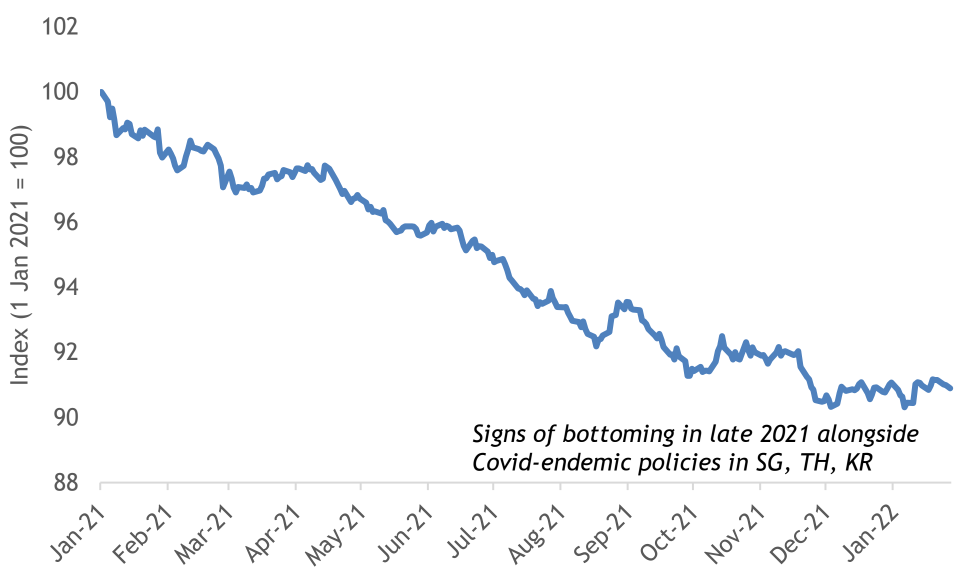
We break them down to 5 main categories namely (1) reopening plays; (2) G7-China divergent play; (3) commodity thematic; (4) Asean policy divergence FX bias and (5) USD – the long and short of it.

(1) Covid-endemic and Reopening Play

Certain countries such as Singapore, Thailand and Korea have adopted a committed stance towards Covid-endemic and reopening policies. In Singapore and Korea, Covid stringency data shows that domestic restrictions have not been tightened significantly despite the ongoing Omicron wave. In Thailand, the government has announced that it will lift the suspension of "Test and Go" from 1 Feb 2022, which means re-implementation of quarantine-free travel for foreign visitors. In contrast, China and Taiwan have largely pushed ahead with zero-Covid policies in attempts to eliminate Omicron from communities. In the event that larger clusters of new cases lead to sudden curbs and start-stops in activity in the latter group of countries, drags on growth and sentiments could be relatively larger.

In a Covid-policy divergence sense, there is a good chance for FX such as SGD, THB, KRW to outperform TWD, CNH in 2022. We construct a basket of equal-weighted long SGD, THB, KRW, versus short TWD, CNH, and note that the index has fallen by around 9% since start of 2021 (i.e., index level at 91 on 27 Jan 2022). Indeed, the index shows signs of bottoming in recent months as Covid-endemic policies take hold in Singapore, Thailand and Korea, mitigating expected drags to economic activity.

Fig 22: Equal-weighted Long SGD, THB, KRW versus Short TWD, CNH, Indexed to 1 Jan 2021



Source: Bloomberg, Maybank FX Research & Strategy

(2) G7-China divergent play

As China struggles to support growth and easing gains traction there, we see opportunity for policy divergent plays with other central banks. Given markets' tendency to quickly price in Fed's hawkish shift, we turn our attention to other hawks that have slipped under the radar. RBNZ, BoE and BoC are seen to be on the hawkish spectrum with RBNZ, BoE already hiked policy rates ahead of the Fed. BoC is almost certain to tighten in Mar given closed output gap. RBA is determined to be a policy laggard but that also gives AUD plenty of room to catch-up with the rest. Expectations are for the central bank to potentially hike cash target rate this year instead of the 2023 flagged by Governor Lowe as latest labour and inflation data came in strong. That said, AUD, NZD, CAD and GBP are risk-sensitive and their recent pullbacks provide more room for appreciation against CNY and JPY (easing PBoC, relatively dovish BoJ).

We favour long CAD, AUD and NZD against the CNY and to some extent, JPY. Particularly, AUDCNH has formed a falling wedge with the apex potentially forming a double bottom at around 4.4580. Prefer buy towards that level (spot at 4.5125) for target at 4.5570 before the next at 4.6390. Stoploss at 4.3883. Risk-reward ratio of 1:2.6.

(3) Commodity thematic

To some extent, we have taken a glass half-full approach for 2022 and look for recovery to broaden even as growth in some major countries have peaked. The push for climate change goals and infrastructure plans potentially boost demand for various commodities including transition metals (Copper, Nickel) amongst others such as crude oil. The geopolitical tensions over Ukraine also present upside risks to crude oil prices. **We are thus positive on AUD, IDR, MYR and CAD vs. net energy importer INR.**

(4) ASEAN policy divergence FX bias

On a broad bias perspective re Asean policy divergence, we maintain a positive bias for SGD vs. ASEAN peers such as MYR and PHP. MAS was the first mover back in Oct and could possibly tighten again via re-centering and slope adjustment in Apr-2022 while BNM and BSP may only commence tightening in 4Q 2022.

But from a FX positioning perspective using volatility-adjusted risk reversals, our estimated z-scores indicate crowded bullish bets on SGD (+2 standard deviations) while MYR and PHP are least crowded. Technically, we observed SGDMYR and SGDPHP may have topped, with RSI turning lower from overbought conditions while bullish momentum waned. We see room for technical correction lower. Rule of thumb is not to fight the market despite core bias but to look out for dips (towards our support levels) to re-initiate tactical long SGD vs. MYR and PHP to proxy for policy divergence bias heading into Apr's MAS MPC.

- SGDMYR could correct lower towards 3.1020 (21 DMA), 3.0960 (200 DMA). A stretch towards 3.0860 (61.8% fibo retracement of Nov-2021 low to Jan-2022 high) is not ruled out. Spot ref last at 3.1120 levels. Resistance at 3.12.

- SGDPHP's turn lower may already have started, after hitting a high of 38.25 (25 Jan). Last at 37.97. Next line of defence at 37.90 (21 DMA), 37.83 (23.6% fibo retracement of Dec-2021 low and Jan-2022 high). Decisive break below these levels could signal deeper correction towards 37.57 (38.2% fibo) and 37.36 (50% fibo). Price action needs to be monitored closely. Resistance at 38.25 (prev high) and 38.50 (2019 levels).

IDR and THB could be next in line to play catch up if BI and BoT indeed tighten next in 2Q and 3Q, respectively (based on our house view). But looking at FX positioning, both THB and IDR seeing long positioning being built up, with IDR going into overcrowded territories. We think risk-reward does not favor any relative trade for IDR and THB. We steer clear for now but keep a close watch to buy into when positioning is less crowded.

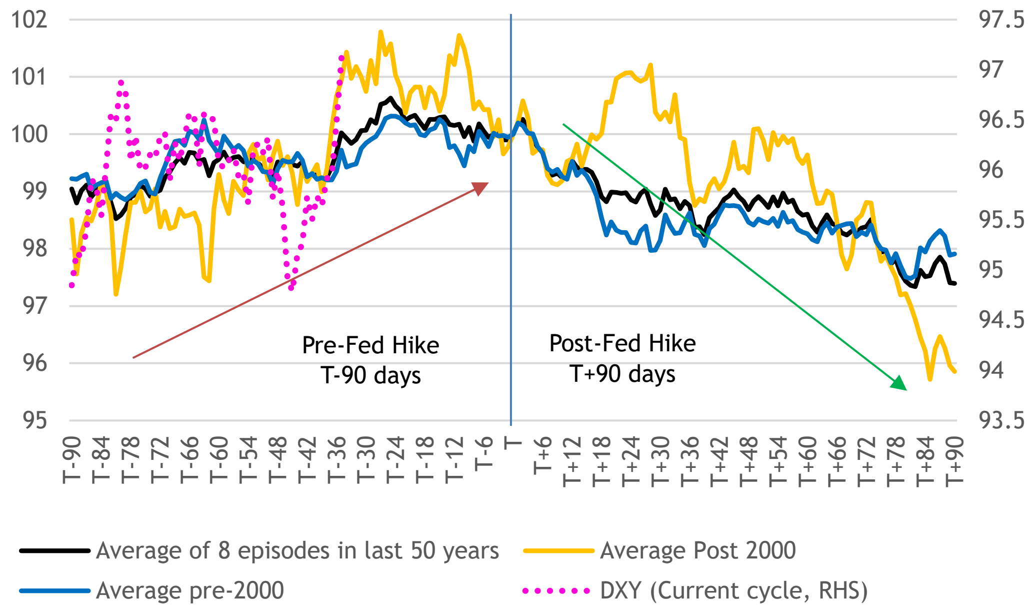
(5) DXY - the Long and Short of It

While history may not necessarily repeat itself and one may also argue that the macro landscape is different from the past, we nonetheless still like to draw your attention to USD behavior in the past cycles in the last 50 years for reference and we overlay the current DXY (making the assumption that Fed would hike on 17 Mar 2022.

Historically as seen in past 7 Fed rate hike cycles over the last 50 years, the 90 days run-up to Fed's first rate hike is typically supportive of DXY strength and at times, can overshoot before easing into first rate hike. Hence our bias for tactical long DXY in current period in the lead up to Mar-2022 rate hike.

But post-first Fed hike also witness the DXY declining by 2% to 4% on average in a T + 90 trading days window as USD long positions unwound post-event risk, hence supporting our bias to sell USD strength.

Fig 23: Current Cycle DXY Charting a Similar Pattern to History



Source: Bloomberg, Maybank FX Research & Strategy

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