

## FX Insight

# SGD NEER Update and Proxy Basket for Preferred Play

### Opportune Time for SGD NEER Re-calibration; Proxy Basket

Given the recent focus on tame inflation and softer growth outcomes in Singapore, and increasing discussion of whether the MAS will ease monetary policy in October, we think that it could be an opportune time to update our SGD Nominal Effective Exchange Rate (NEER) model.

The new model sees SGD NEER trading near the top of the policy band (+1.7% above mid-point) currently. This, alongside a modest likelihood of policy easing in Oct, could portend a softer SGD NEER by year-end. While the USDSGD pair is often used to express a view on the SGD NEER, we caution that a dovish Fed could continue to impart some softness to USD in 2H as well. We hence favour a weighted “basket” approach where we Long USD, CNH, MYR, IDR, PHP (30%/35%/20%/10%/5%) vs. Short SGD. We show that this proxy has the potential to track the SGD NEER relatively well in the interim, while also returning overall positive carry.

### Potential Technical Recession Increases Likelihood of Easing

Recent downsides in macro indicators, which prompted a call for a potential shallow recession in 3Q by our Economist team (see Report: Manufacturing Down, Recession Looms; Cut 2019 GDP to +1.3%), could potentially increase the likelihood of a policy easing in October by the Authorities.

We think potential factors which could nudge MAS further towards a more dovish stance would include a softer medium-term oil price outlook and annual GDP growth estimate falling below 1%. Authorities have said that the current 1.5% to 2.5% official growth range is under review, pending 2Q data (*Advance estimates* for 2Q GDP before 12 July).

### Two-step SGD NEER Re-calibration

In the re-calibration exercise, potential components in the actual MAS NEER basket were first distilled from a list of top trading partners for Singapore, via studying trade data trends since the Global Financial Crisis. Second, econometric methods were used to derive currency weights which would lead to minimised tracking errors to the historical MAS NEER series.

We retain our assumptions of a +/-2% width trading band and an appreciation slope of 1.0% with regards to current policy. With USDSGD at 1.3560 this morning, our updated model shows that the SGD NEER is estimated to be 1.7% above mid-point, versus 1.3% in our previous model.

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## Model Recalibration Details

We first look at how broad trade trends have shifted since the Global Financial Crisis. Singapore's trading partners' shares in its overall trade basket (inclusive of both merchandise goods and services) over two broad five-year periods can be seen in Table 1. The full list of countries we consider is longer, but the Top 10 trading partners is shown here for reference.

**Table 1: Shares in Total SG Trade (Merchandise Goods and Services)**

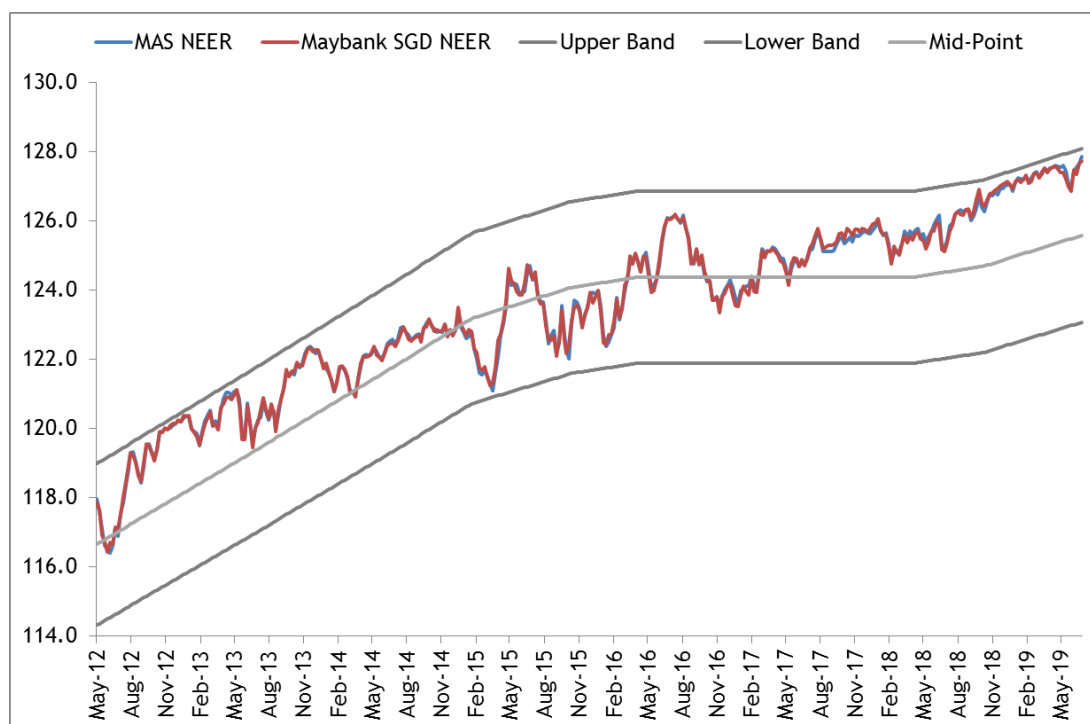
Average 2008 - 2012		Average 2013 - 2017	
Country	Share in Total SG Trade (%)	Country	Share in Total SG Trade (%)
USA	10.4%	China	11.4%
Malaysia	10.0%	USA	10.7%
Euro Area	9.9%	Euro Area	10.5%
China	9.4%	Malaysia	8.9%
Indonesia	7.0%	Hong Kong	6.1%
Japan	6.0%	Indonesia	5.6%
Hong Kong	5.9%	Japan	5.4%
Korea	4.4%	Taiwan	4.8%
Taiwan	4.0%	Korea	4.1%
Australia	3.3%	Australia	3.4%

Source: CEIC, Maybank FX Research & Strategy Estimates

As expected, China's share in our trade basket jumped in the latter period, while US' and Euro Area's average shares also saw modest increases. Trade shares of Malaysia and Indonesia declined by more than 1%-point. This shift in trading patterns confirms our intuition that an approach which uses different weights for different periods in computing the SGD NEER might work better than an approach using fixed weights throughout.

To this end, we identify the 14 most important trading partners for Singapore, and utilise an econometric approach to derive their implied weights in the MAS NEER basket. Weights were estimated for two different periods: (i) Jan 1999 to Mar 2012, (ii) Apr 2012 to May 2019. Jan 1999 is the first data point in the MAS NEER series, while Apr 2012 was chosen as a breakpoint of sorts as it was the only time in the last decade that MAS had adjusted both policy slope and band during the policy cycle. It also left us with sufficient data points to fit the second weighting regression.

We then proceed to compute the SGD NEER index, with the two sets of estimated weights applied across their respective periods.

**Chart 1: Estimated SGD NEER Index vs. Actual MAS NEER**

Source: Maybank FX Research & Strategy Estimates

The estimated Maybank SGD NEER (red) in the chart above tracks the actual MAS NEER (blue) relatively well. Tracking error has fallen to around 0.08% post model re-calibration.

### Preferred Proxy Play

With the SGD NEER estimated near the top of the trading band (+1.7% above mid-point), and increased likelihood for MAS to ease policy in Oct, risk-reward asymmetries could favour “shorting” the SGD NEER. Nonetheless, it would be too costly to transact in numerous currency pairs within the NEER basket, and negative carry returns might also weigh on the portfolio in some instances.

We hence look for a quick “proxy basket” of four or five currencies, which might reasonably track the performance of the SGD NEER in the interim, while still likely returning positive carry. We first identify several currencies with non-negative 1 Year Government Bond Yield Differentials when compared with SG Government Bonds.

**Table 2: 1 Year Government Bond Yield Differentials (vs. SG Bond)**

Currency	Yield Differential (%)
IDR	4.5
INR	4.1
PHP	2.9
MYR	1.3
CNH	0.6
USD	0.0

Source: Bloomberg (Rates as of 1 July 2019), Maybank FX Research & Strategy

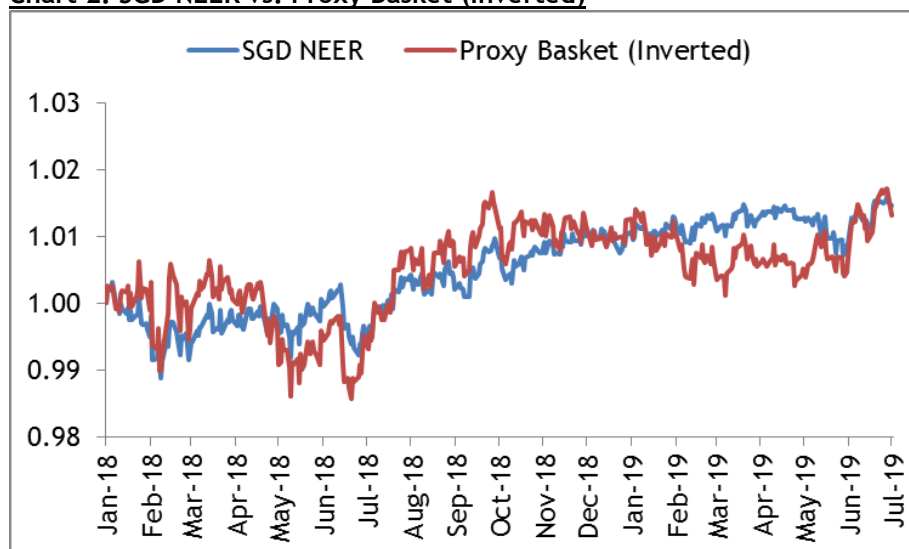
**Table 3: Proxy Basket Weights**

Currency	Weight (%)
USD	30
CNH	35
MYR	20
IDR	10
PHP	5

Source: Maybank FX Research & Strategy

We then proceed to derive a proxy basket according to the weights in Table 3. Despite its neutral yield differential with SGD bonds, USD is included in the proxy basket due to its (likely) significant weight in the actual NEER basket.

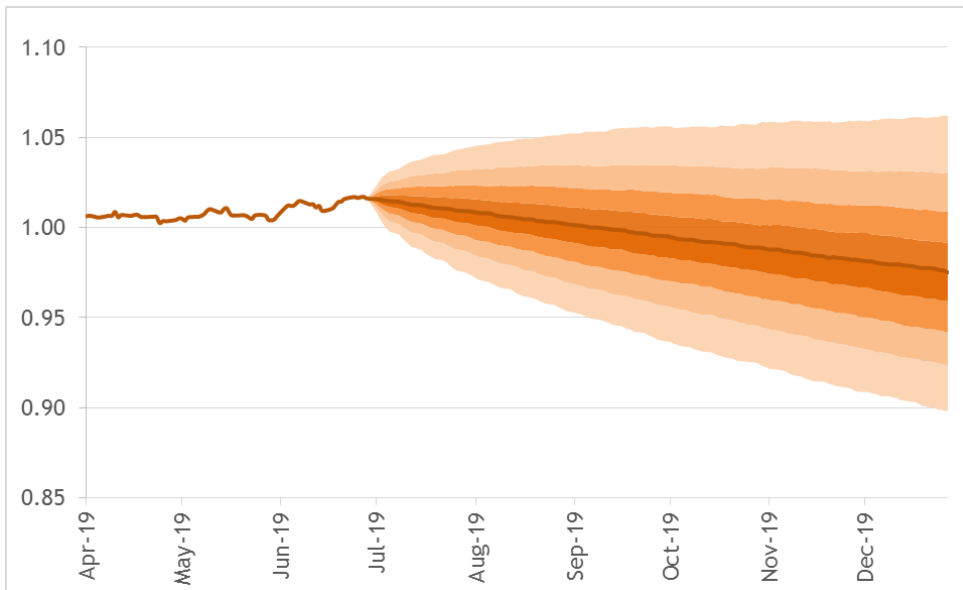
We also caution that due to the selection criteria (i.e., non-negative bond differentials vs. SG bonds), certain likely components in the SGD NEER basket such as JPY and EUR are left out, and we sacrifice some tracking accuracy. Nonetheless, correlation of the proxy basket from Jan 2018 to June 2019 is still reasonably robust at around 80%. (See Chart 2)

**Chart 2: SGD NEER vs. Proxy Basket (Inverted)**

Source: Maybank FX Research & Strategy Estimates

Note: The proxy basket (which consists of weighted XXX-SGD pairs, where XXX refers to individual currencies in Table 3) is inverted in the chart to show performance vis-à-vis SGD NEER. Values are indexed to 1.00 as of 1 Jan 2018.

As a last quick check, we utilise the simulation approach outlined in our Insights piece previously ([\*Exploiting the Behaviours, Asymmetries and Dispersions in FX\*](#)) to see what a potential distribution of outcomes surrounding the proxy basket above could look like. Notably, this approach requires some forecast assumptions regarding the underlying behaviour of certain financial indicators used in the simulations, and as such can be relatively sensitive to the period where these behaviours (means and standard deviations) are extracted from. In this case, we choose 1H 2019 for simplicity.

**Chart 3: Potential Distribution of Outcomes of Proxy Basket (Inverted)**

Source: Maybank FX Research & Strategy Estimates

Note: Dark line represents actual historical data up to end-Jun 2019 and median simulated trajectory. Each colored shading band is a 10% outcome range, with the top and bottom bands representing 90-percentile and 10-percentile outcomes respectively. Values are indexed to 1.00 as of 1 Jan 2018.

Despite the wide range of outcomes, as is common for such simulation-based approaches, there seems to be a modest bearish bias on the (inverted) proxy basket.

This lends some support to our view that longing the proxy basket, i.e., Long USD, CNH, MYR, IDR, PHP (30%/35%/20%/10%/5% weights) vs. Short SGD, has the potential to do well in an environment of continued trade truce and broad monetary accommodation. Downsides would also likely be limited by the positive carry and MAS policy bias.

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