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FX Insight

ASEAN FX: Limited Impact of Fed’s Balance Sheet Reduction

Analysts

Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com.sg

Leslie Tang
(65) 6320 1378
leslietang@maybank.com.sg

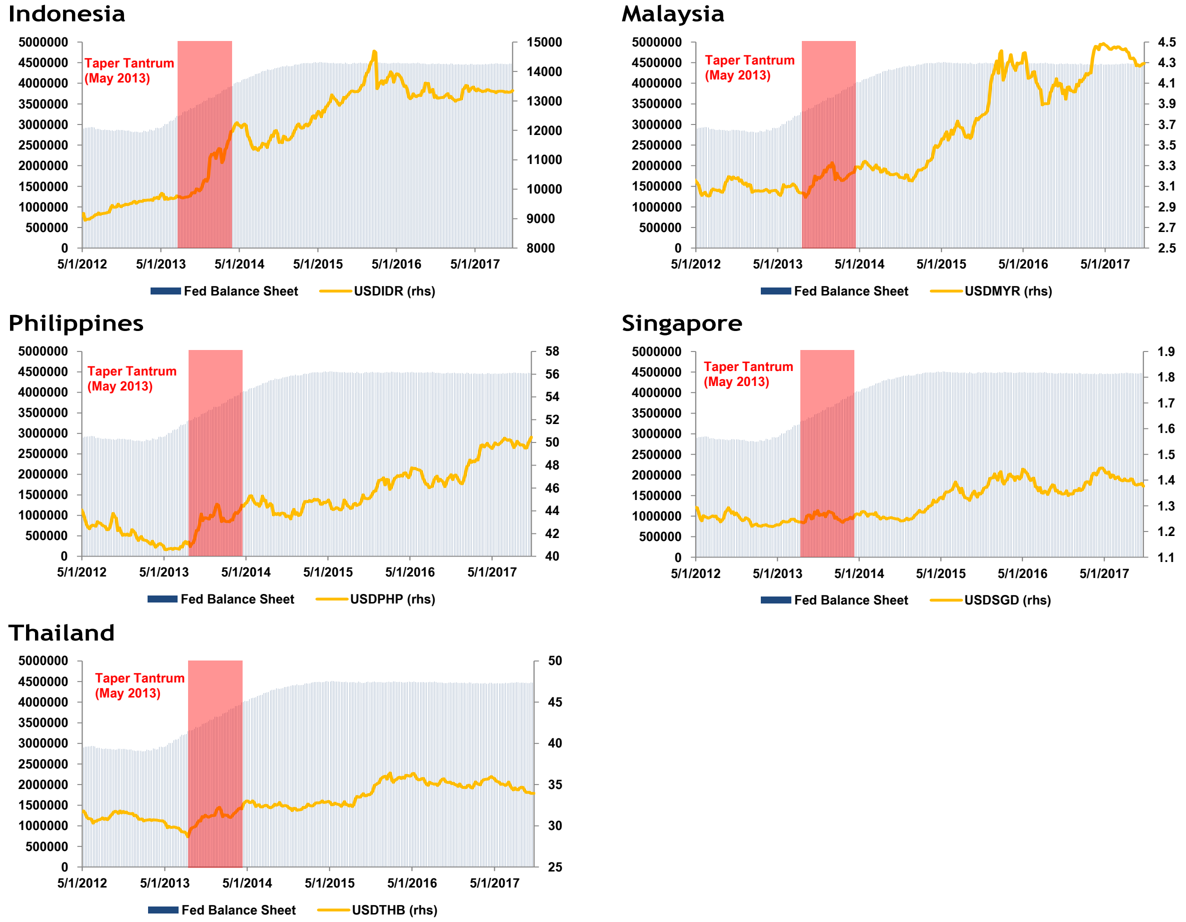
Christopher Wong
(65) 6320 1347
wongkl@maybank.com.sg

Fiona Lim
(65) 6320 1374
fionalim@maybank.com.sg

The Fed’s balance sheet is back in focus with the Fed announcing that a gradual balance sheet reduction would start later in 2017. We expect this reduction to begin in 4Q 2017 after the Fed hikes its short-term rate by 25bp for the third time this year at its 19-20 Sep FOMC. The unwinding could start as soon as Oct. The current balance sheet size is at USD4.5tn.

The Fed will shrink its securities holdings in its balance sheet that were accumulated from the three previous rounds of assets purchases (QE). Since Fed Chair Yellen announced the end of its asset purchase program on 29 Oct 2014, the Fed fully reinvests the proceeds from matured securities to keep the balance sheet at or around USD4.5tn.

Chart 1: Taper Tantrum Reverses ASEAN FX Gains From US QE



Source: Bloomberg, Maybank FX Research

How Fed Intends To Roll-Back Its Balance Sheet

There are two ways that the Fed can shrink its balance sheet. It can sell securities on its balance sheet or it can stop reinvesting maturing securities. The preference of the Fed appears to be the latter with the plan to allow USD10bn of maturing securities (USD6bn in UST and USD4bn in MBS (mortgage-backed securities)) to run off. It will increase the pace of reduction by USD10bn (USD6bn in UST and USD4bn in MBS) every three months over 12 months until they reach USD50bn (USD30bn in UST and USD20bn in MBS). Based on this schedule, the cumulative amount of balance sheet in the first year of operation will be USD350bn. According to the Kansas Fed on 10 May 2017, their analysis showed that a $675 billion reduction in the Fed's balance sheet over a two-year horizon is about equivalent to a 25 basis point hike in the funds rate.

Given the size of the balance sheet, the question arises is how the ASEAN FXs will be most impacted from this unwinding. As we had seen from the episode when the Fed announced it was tapering its asset purchased program in May 2013 that resulted in what is now known as the 'Taper Tantrum' (see ***Chart 1***), could a similar situation manifest itself with the Fed's unwinding of the balance sheet.

Limited Impact Of Balance Sheet Reduction On ASEAN FX

One possible transmission mechanism in which the unwinding of the Fed's balance sheet will impact on the ASEAN currencies is via UST yields. The reduction in the amount of UST that Fed holds should weigh on US asset prices, and this in turn lifts UST yields and USD higher. This in turn could trigger a sell-off in emerging market assets back to the US as investors seek higher returns, pressuring ASEAN FXs lower.

Examining the sensitivity of ASEAN FXs to changes in 10Y UST yield should provide some insights into which currencies among the ASEAN economies will be most impacted by the Fed's move to reduce its balance sheet.

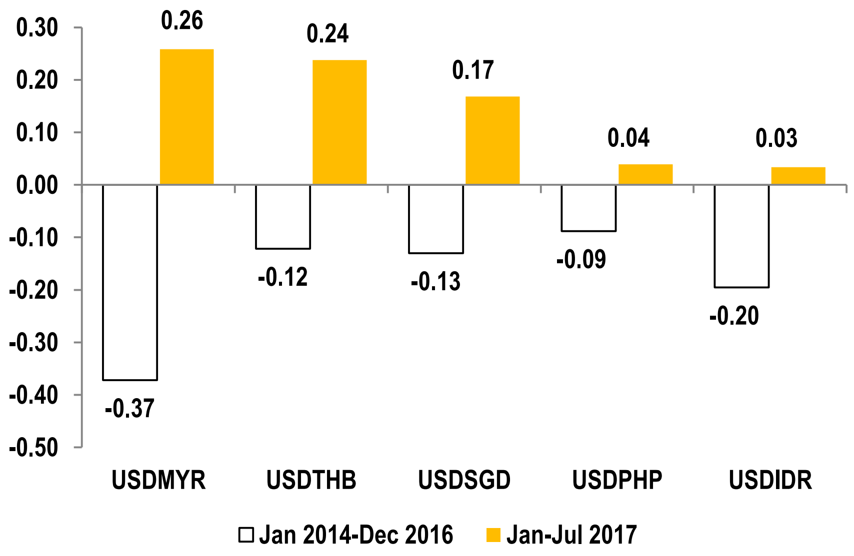
Our analysis shows that the sensitivity of the USD/ASEANs to moves in the UST yields has flipped into positive territory in 2016 (***Chart 2***). Previously, higher UST yields led to dips in USD/ASEANs as higher yields were suggestive of improvement in US growth prospects and hence ASEAN growth. Now, a rise in UST yields lifts USD/ASEAN higher as portfolio inflows to ASEAN assets slow in search of higher yielding ones in the US.

In addition, the results from our analysis showed that the shrinking of Fed balance sheet via UST yields is likely to impact the USDMYR the most. This is followed by the USDTHB and USDSGD. It would appear that the more open economies in the region are most sensitive to moves by the Fed to normalize its balance sheet. The least sensitive to UST yield moves are the USDPHP and USDIDR.

The increased sensitivity in the USDMYR to moves in 10Y UST yield is probably due to the breakdown in MYR's correlation to global oil prices as the oil share of the Malaysian budget has fallen. Nevertheless, improved domestic growth fundamentals as well as BNM's recent initiatives to boost bond market liquidity and allowance for additional hedging flexibility have boosted investor confidence and hence mitigated the impact from higher UST yields.

We do not expect USD/ASEANs to climb as aggressively as it did in 2013 during the Taper Tantrum. This is because fundamentals in most ASEAN economies have improved since 2013 with smaller current account deficits, higher foreign reserves and strengthened central bank regulations on hot money flows.

Chart 2: USDMYR, USDTHB & USDSGD Most Sensitive To UST Yield Increase



*Equation: log(USD/ASEAN) = c + b*log(10Y UST yield) + error term*
Note: (1) OLS regression analysis was used to determine the sensitivity of the ASEAN FX (b in the equation) to 10Y UST yield for the two time periods using daily data.
(2) The sensitivity (b in the equation) is plotted above
Source: Bloomberg, Maybank FX Research

Forecasting USD/ASEAN Moves Based On A US Normalization Scenario

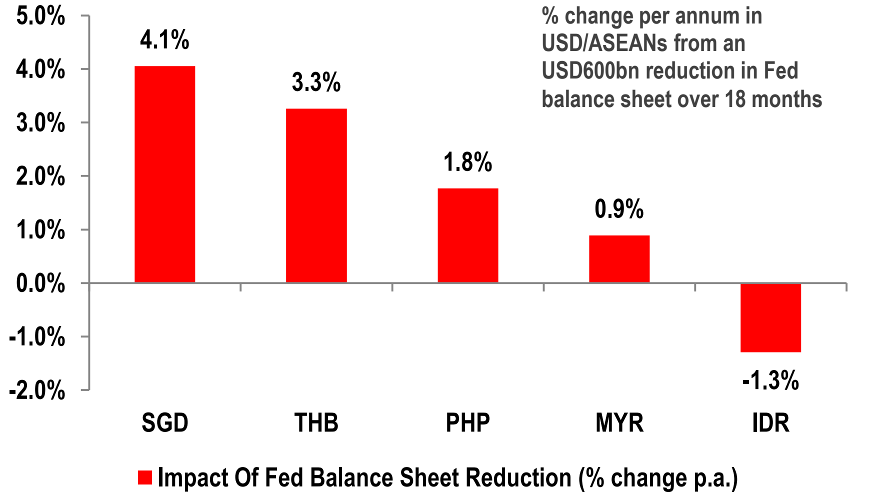
We attempt to assess the impact of a possible US balance sheet normalization scenario on USD/ASEAN over the next 18 months (we assume other factors remaining constant). Our model assumes the Fed balance sheet is reduced by USD600bn over 18 months (we apply a similar trajectory as the Fed based on Kansas Fed study, *Macro Bulletin - Forecasting the Stance of Monetary Policy under Balance Sheet Adjustments (10 May 2017)* - assumption of an USD675bn reduction over a 2-year period).

We used the following simultaneous equations to forecast USD/ASEAN:

*(1) log(10Y UST Yield) = c + d *log(Fed Balance Sheet levels) + error term*
*(2) log(USD/ASEAN) = c + b*log(10Y UST yield) + error term*

where equation (1) is used to forecast the 10Y UST yields from a reduction in the Fed balance sheet. The resultant 10Y UST yields are then fed into equation (2) to determine the levels of USD/ASEANs at the end of 18 months of balance sheet normalization.

Chart 3: Forecast of ASEAN FX Suggests Impact Of Fed Balance Sheet Reduction Muted



Simultaneous Equation Model:
*Log(10Y UST Yield) = c + d *log(Fed Balance Sheet levels) + error term*
*Log(USD/ASEAN) = c + b*log(10Y UST yield) + error term*
Note: Assumes Fed balance sheet reduction of USD600bn from Jul 2017 to Dec 2018; based on Kansas Fed assumption of an USD675bn reduction over a 2-year period.
Sample period: Jan 2000 to Jun 2017
Source: Bloomberg, Maybank FX Research

We plot our results of 'b' in equation (2) in **Chart 3** above. Our model suggests the impact of a shrinkage in the Fed's balance sheet over a 18-month period on ASEAN FX is muted. An USD600bn reduction in the Fed's balance sheet by end-2018 results in the USDSGD, USDTHB and USDPHP rising by 4.1%, 3.3% and 1.8% per annum respectively by end-2018 from current levels (holding other factors constant). A smaller impact is seen for the USDMYR from the Fed balance sheet reduction, rising by 0.9% by end-2018, while the USDIDR could dip by 1.3% at the end of 2018.

We would like to highlight that some of the effects of the Fed normalization and then proxied via bond yields and sentiment in our analysis could be mitigated by other countervailing factors such as portfolio inflows, domestic fundamentals, commodity prices and USD dynamics. Furthermore, the Fed normalization assumptions built-in in our analysis could be different.

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Saktiandi Supaat	Christopher Wong	Fiona Lim	Leslie Tang
Head, FX Research	Senior FX Strategist	Senior FX Strategist	Senior FX Strategist
saktiandi@maybank.com.sg	wongkl@maybank.com.sg	Fionalim@maybank.com.sg	leslietang@maybank.com.sg
(+65) 63201379	(+65) 63201347	(+65) 63201374	(+65) 63201378