Maybank

Macro | FX Research and Strategy

Global

FX Insight

Differentiated FX Play in Choppy Times

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FX Sensitivity to Trade War, EM Risks and Fed

Our FX sensitivity study which takes into consideration current market dynamics, shows that CNH, INR, AUD and NZD tend to be most sensitive in the combined event of re-escalation in US-China trade tensions, intensification of EM sell-off and monetary conditions at risk of further tightening. KRW tends to be more sensitive in the event US-China trade tensions escalate. IDR stands out in the event of EM sell-off intensifying and monetary conditions at risk of tightening. Currencies that are least sensitive to the above market dynamics include JPY and CHF, and to some extent, SGD. These currencies are considered relative "safe harbours" to hold on to, in times of stresses.

Credible Policy Measures Can Support Sentiment

Recent policy measures from the region including Turkish rate hike, China PBoC's re-introduction of counter-cyclical adjustment factor (CCAF) to daily RMB fixing, measures from India to support the currency as well as Indonesia's commitment and priority to stabilise currency should anchor sentiment and slow the pace of depreciation in the AXJ complex. Further stabilisation in sentiment accompanied by EM/G7 FX vol ratio falling, could see AXJ FX recover. We also observed that inflexion points at extreme level above historical average for EM/G7 FX ratio tend to see a sharp snapback in USD/AXJs.

Favor Long INR, IDR, EUR, GBP vs. Short CNH, KRW, AUD

In summary, caution remains warranted on AXJ FX as trade war development remains highly fluid (eyes on China's move next) and ahead of the upcoming FoMC meeting (which could keep UST yields and USD supported). Relative stabilisation in EM FX amid recent policy measures could favor tactical longs in IDR and INR vs. shorts in CNH and KRW (trade war) within the AXJ space. Given the large sell-off this year and its respective high betas, a recovery in sentiment in the EM FX space could see IDR and INR retrace some of its earlier losses. Amongst the G7 space, we maintain our constructive outlook on EUR and GBP over antipodeans (AUD and NZD) amid monetary policy divergence and antipodeans' high sensitivity to trade war development.

Technically, we believe USD may have made an interim top and further upside could be limited. Markets have started to trim USD net long position. Further unwinding of USD long could exert downside pressure on USD.

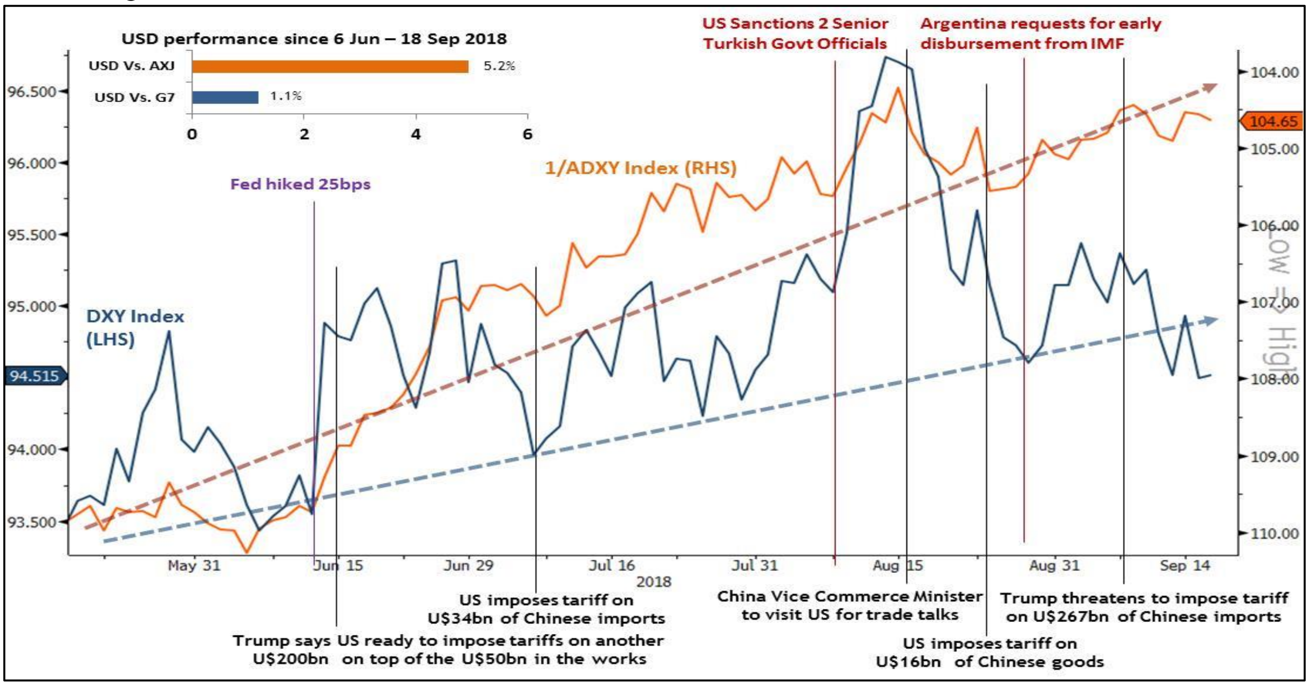
Need for Differentiation When Interpreting USD Strength

The run-up in USD strength since Apr 2018, on the back of US data outperformance, Fed's hawkish rhetoric, re-escalation of US-China trade tensions and EM FX sell-off has started to show signs of moderation, of late. But we stress that some degree of differentiation is needed when interpreting USD strength.

DXY (or dollar index), commonly referred as the dollar proxy has fallen by 2% since mid-Aug and this was largely due to the recovery in the EUR and GBP (both made up nearly 70% of the DXY). This can be attributed to some clarity on Italy budget and renewed hopes that a *Brexit* deal is within reach.

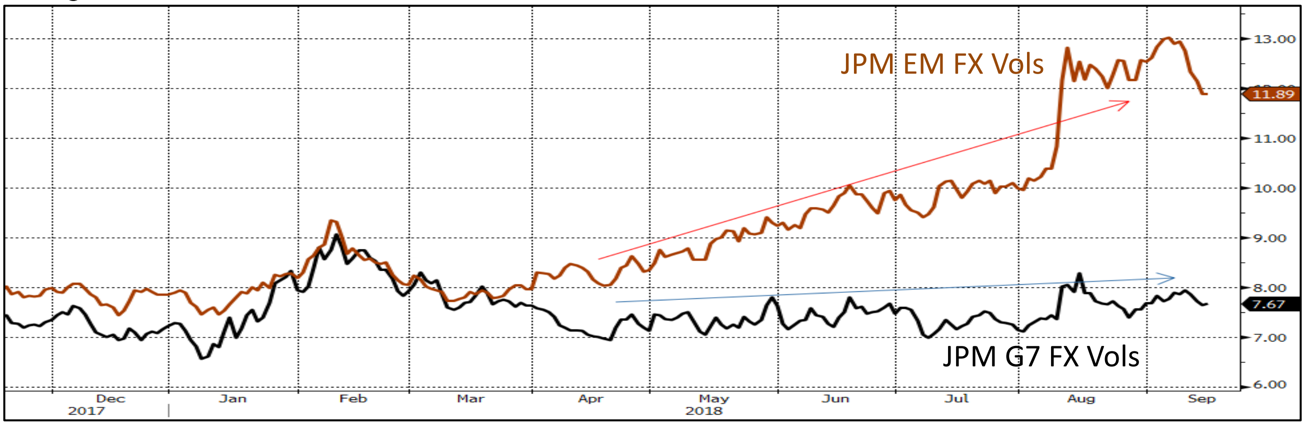
However the same cannot be said for USD vs. Asian FX, the latter which the USD has continued to trade near recent highs amid lingering concerns of trade tensions re-escalating and spill-over risk from the sell-off in BATS FX (Brazilian Real, Argentine Peso, Turkish Lira and South African Rand) which sparked fears of contagion. Higher UST yields in the lead up to upcoming FoMC meeting may be an additional factor (tightening monetary conditions) keeping the USD strength broadly supported.

USD Strength More Pronounced vs. AXJs



Source: Bloomberg, Maybank FX Research & Strategy

Divergence between EM FX Vols and G7 Vols



Source: Bloomberg, Maybank FX Research & Strategy

Indonesia and Malaysia Amongst Most Vulnerable in ASEAN

Our Economists shared in their recent report (see here) a Macro Vulnerability Score Card which they constructed to rank selected EM and ASEAN economies being susceptible to market and currency pressures as well as contagion. The scorecard took into consideration macro balances, external financing requirement, real interest rates, reserves adequacy and CDS spreads. They believe currency movement in EM and ASEAN have largely priced in and reflected the macro fundamentals and risks. Policies and politics are the ones to watch going forward.

Selected EM and ASEAN Countries		Position	Ranking #						
			Total Score	Macro Balance	External Financing Requirement	Real Benchmark Interest Rate	Adequacy of External Reserves	CDS Spread	Chg in CDS Spread
Highest Risk	Turkey	1	15	4	2	2	3	2	2
	Argentina	2	22	1	4	13	2	1	1
	South Africa	3	23	5	3	6	1	4	4
	Brazil	4	32	2	8	7	9	3	3
	Indonesia	5	40	6	6	9	8	6	5
	Malaysia	6	42	11	1	10	5	8	7
	Mexico	7	45	7	5	11	6	7	9
	India	8	48	3	10	8	10	9	8
	Philippines	9	49	8	9	1	11	10	10
	Russia	10	52	9	7	12	13	5	6
	China	11	57	10	13	5	7	11	11
	South Korea	12	58	12	12	4	4	13	13
Lowest Risk	Thailand	13	63	13	11	3	12	12	12

Note: Countries with lowest score represent highest vulnerability
Source: MKE Economics Research (7 Sep 2018)

Which Currencies Are Most Sensitive to Current Market Dynamics?

We extend the fundamental framework further to take into consideration the current market dynamics, including trade war tensions between US and China, EM FX sell off and monetary conditions (in light of upcoming FoMC meeting on 26th Sep) and how these factors may impact currency markets.

From a statistical perspective, we regress selected FX including Asian, antipodeans and safe haven proxies) with trade war tensions (CNH as proxy), EM FX sell-off (BATS FX as proxy) and monetary conditions/Fed's hawkish rhetoric (UST 2Y treasury yield as proxy) and rank these currencies in order of their respective sensitivity.

- **Escalation of trade tensions** between US and China should continue to see most AXJs under pressure. **CNH, KRW, AUD, NZD and INR are the top 5 most sensitive FX** in this space;
- **Sell-off in EM FX** is expected to see **spillover risks to NZD, INR, AUD, IDR and CNH**, in order of sensitivity;
- **Tightening in monetary conditions/ Fed's hawkish rhetoric** leading to FoMC meeting should see **INR, NZD, AUD, IDR and CNH under pressure**.

FX Sensitivity to Market Dynamics

	US-China Trade Tensions	EM FX Sell-off	Monetary Conditions
Most sensitive	CNH	NZD	INR
	KRW	INR	NZD
	AUD	AUD	AUD
	NZD	IDR	IDR
	INR	CNH	CNH
	THB	TWD	PHP
	SGD	THB	CHF
	CAD	KRW	CAD
	TWD	MYR	TWD
	IDR	PHP	KRW
	MYR	SGD	THB
	PHP	CAD	MYR
	CHF	JPY	SGD
Least sensitive	JPY	CHF	JPY

Note: Currencies as Y variables regressed against market dynamics as X variables based on daily change data from 1 Jan 2018 to 11 Sep 2018. EUR and GBP are excluded from the analysis due to idiosyncratic factors at home.
Source: Bloomberg, Maybank FX Research & Strategy

Overlaying the 3 market dynamics, we see a similar pattern where **CNH, INR, AUD and NZD tend to be most sensitive in the combined event of re-escalation in US-China trade tensions, EM sell-off intensifies and monetary conditions at risk of further tightening**. KRW tends to be more sensitive in the event US-China trade tensions escalate. IDR stands out in the event of EM sell-off intensifying and monetary conditions at risk of tightening.

In light of the above market dynamics worsening, our study suggest CNH, INR, AUD, NZD, KRW, IDR may continue to underperform.

In particular on INR (given that it has declined the most amongst Asia FX and is highly sensitive to global macro events), the elevated oil prices and downward spiral in the rupee are likely to keep the prospect of another rate hike in Oct by RBI very much alive and the local bond market under pressure again. This feeds into a vicious circle of rupee weakness, worsening current account deficit, inflation risks, possibility of another policy rate hike and then further outflows. The oil import bill has risen from an average of 20% of the total import bill to 28% in Jul 2018. The trade deficit has also risen to highs not seen since May 2013. With Iran still facing sanctions from the US, Hurricane Florence posing risks to US supply in the short term, EIA downgrading the US production forecast for 2019, it is hard to see a meaningful correction for the brent crude price. However, the authorities might step in to do more. Recent measures suggest that the central bank and the government are pro-active in managing the rupee. So while INR could still decline further, the mileage for rupee bears might be less than before. (See here for FX Update on INR published last Fri)

Currencies that are least sensitive to the above market dynamics include JPY and CHF, and to some extent, SGD. These currencies are considered relative "safe harbours" to hold on to, in times of stresses.

Credible Policy Responses Can Help to Stabilise Sentiment

While **caution remains warranted especially on the US-China trade war front, we see signs that the recent sell-off in AXJ FX could stabilise**.

Policy measures from the region including the surprise magnitude of Turkish rate hike, China PBoC's re-introduction of counter-cyclical adjustment factor (CCAF) to daily RMB fixing, potential measures from India to support the currency as well as Indonesia's commitment and priority to stabilise currency **should anchor sentiment and slow the pace of depreciation**. Further stability in Asian FX would require proven policy credibility (ample tools, FX reserves, authorities commitment to not fall behind the curve, etc.). Some recent measures around the region include:

- Argentina's Economy Minister is expected to present austerity-driven budget measures to Congress today (17 Sep) with the objective of eliminating the budget deficit to zero by 2019, to shore up investor confidence as the government seeks IMF support. IMF officials were in Argentina (13 Sep) as part of talks to strengthen the program support of the IMF and accelerate the disbursement of a US$50bn rescue lending program to finance its monetary policy. The first tranche of $15bn has so far been disbursed. The IMF has agreed in principle but has requested to the Argentine government to strengthen their economic program. A decision from IMF to accelerate the disbursement could help to mitigate the sell-off in Argentine Peso;

- India announced measures (15 Sep) in attempt to support the Rupee by boosting capital inflows and to narrow the current account deficit. Some of these measures include limiting non-essential imports, withholding tax exemption from Masala-bond issuance, potential removal of caps on foreign ownership of corporate bonds, etc;

- Turkey central bank (CBRT) surprised with a 625bps rate hike (13 Sep), taking benchmark rate to 24% (from previous 17.75%). Markets were initially expecting a hike of around +300bps and had doubts over central bank independence. The larger than expected hike should serve to put an emphasis on central bank independence and the Turkish Lira (TRY) subsequently appreciated by over 6% at one point. CBRT pledged to enact strong monetary tightening in order to support price stability amid the recent stresses in Turkish assets (see here for report last month on trigger for sharp depreciation in TRY). Relative stability in TRY in the interim has helped to provide an anchor for AXJs. Focus next on Turkey's economic plans which is expected to focus on keeping inflation under control, dealing with high interest rates on loans and narrowing the current account deficit (to be announced on 20 Sep). The government's Medium Term Program, includes TRY35bn of spending cuts and revenue-raising measures to keep the budget deficit under 2% of GDP.

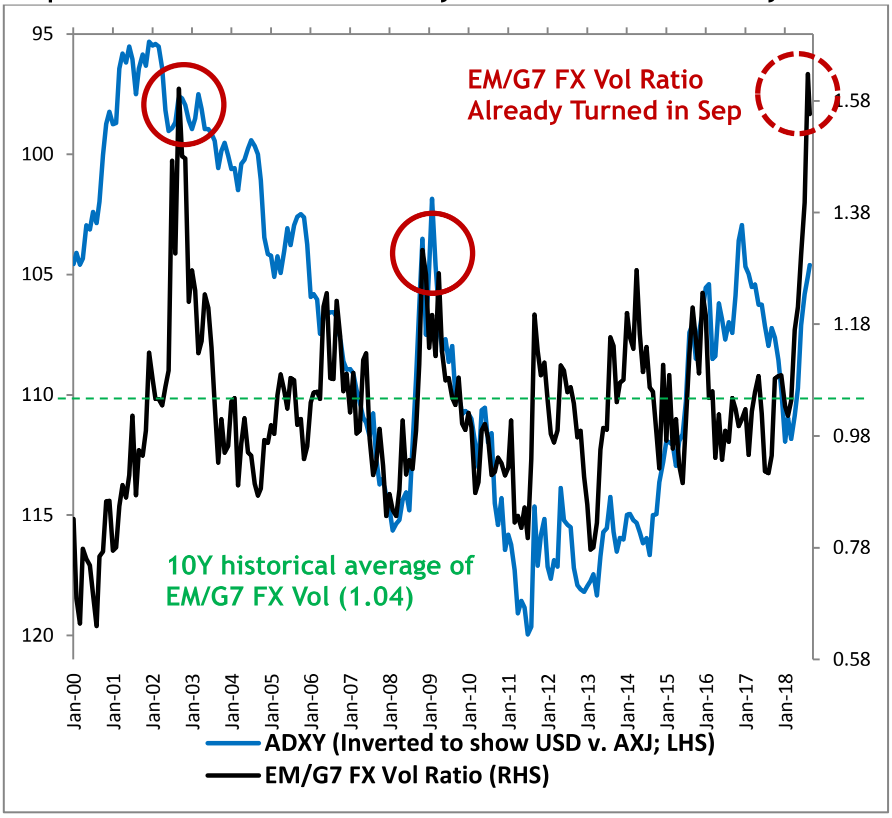
- PBoC announced (24 Aug) that it had re-introduced the CCAF for fixing the RMB daily midpoint to keep the currency "basically stable at reasonable equilibrium levels" amid broad USD strength and trade frictions between US and China. The last time the CCAF was introduced back in 26 May 2017, CNY bottomed against the basket and appreciated around 3%. In this episode, we expect the re-introduction of CCAF to shield the RMB from excessive depreciation. In fact our recent study (see here for RMB Watch dated 14 Sep) shows that intra-day trading ranges of USDCNH have narrowed since the re-introduction of the CCAF and this should anchor some degree of stability for AXJ FX.

And we reckon stabilisation in sentiment could ease FX volatility and ease depreciation pressure off AXJs. Our chart below shows that EM/G7

FX Vol Ratio has hit record high of 1.63 in Aug (vs. 10Y historical average of 1.04). This also saw USD/AXJ (ADXY inverted) rising to near 20-month high in Aug.

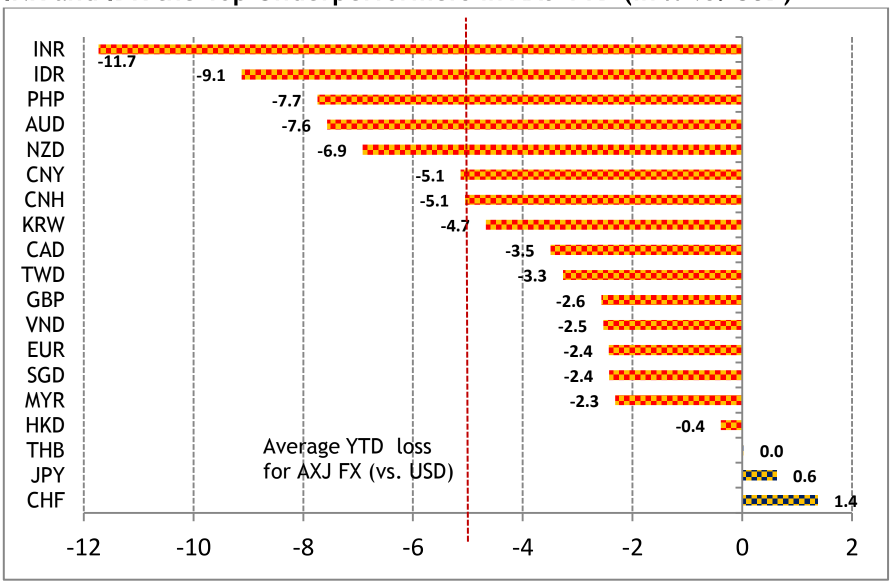
A **recovery in sentiment accompanied by EM/G7 FX vol ratio falling, could see AXJ FX recover.** We also observed that inflexion points at extreme level above historical average for EM/G7 FX ratio tend to see a sharp snapback in USD/AXJ. Previous periods of sharp snapback in EM/G7 FX vol and sharp decline in USD/AXJ were in 2002/03 (deterioration in US twin deficits amid war in middle east and tax cuts by President Bush) and post-GFC 2009.

Snapback in EM/G7 FX Vol Ratio May Lead to Further Recovery in AXJs



Source: Bloomberg, Maybank FX Research & Strategy

INR and IDR the Top Underperformers in AXJ YTD (in % vs. USD)



Source: Bloomberg, Maybank Fx Research & Strategy

But Key Focus Still on US-China Trade War Development and …

Trump administration has confirmed the imposition of 10% tariff on $200bn of Chinese imports, effective 24 Sep 2018. The tariff rate will increase to 25% on 1 Jan 2019 (after US-mid-term elections). Meanwhile the focus is on China's response in terms of retaliation. It is likely that China could possibly skip trade talks amidst US' invitation to China for another round of trade negotiations (as confirmed by White House Advisor Ludlow).

Nonetheless we **believe the gradual step-up in tariff rate over a period of a few months suggest that US is tactically keeping some room for negotiation with China. This may not be as detrimental to risk sentiment**. Indeed taking stock of FX markets today (18 Sep, 2pm SG/Kl time) after the implementation of tariff, most risk proxy FX have already reversed their knee-jerk weakness and are now stronger at the expense of the USD (DXY is now at 6-weeks low).

Earlier last week, Trump was said to potentially impose tariffs on another $267bn of Chinese imports (on short notice) in addition to the $200bn and he followed up today saying that he will immediately pursue tariff on the $267bn if China retaliates. This means a pending total of $467bn of Chinese goods on top of the $50bn that was already imposed with tariffs back in Jun, Aug. The combined earmarked amount of $517bn of Chinese goods subjected to tariff is more than all of US' imports from China in 2017 ($505bn).

While there is a limit to how much more Chinese goods that could be subjected to US tariffs, there is nothing stopping Trump's administration to impose non-tariff measures. Recent development includes potential sanctions against Chinese senior officials and companies over China's treatment of its minority Muslims.

China, on the other hand, is seeking authorisation at a **special meeting at the WTO's Dispute Settlement body on 21 Sep** to impose sanctions on the US. To be sure, China has already said it will retaliate with tariffs on $60bn in US goods if US impose tariffs.

The next 1-2 weeks could be crucial as tensions between US and China could further escalate and expand beyond trade.

… Fed's Hawkish Rhetoric ahead of FoMC Meeting Next Week

Stronger payrolls report (wage growth picks up pace to +0.4% m/m vs. +0.3% prior vs. +0.2% expected while NFP came in much stronger at +204k vs. +194k expected) reinforces the case for Fed to stay on course to tighten at the **upcoming FoMC meeting on 27 Sep (2am SG/KL time)** and perhaps build the case for the 4th rate hike this year. **Fear of Fed picking up pace of tightening could lead to higher rates and keep USD supported in the interim.** In particular recent Fed speaks seemed tilted towards the hawkish spectrum:

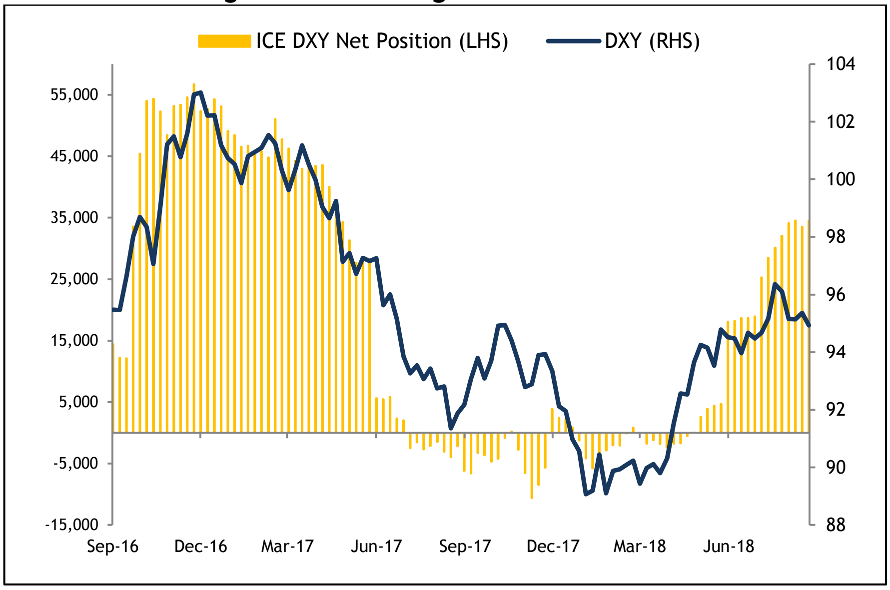
- Fed's Evans (non-voting member this year) said that US economy is firing on all cylinders with strong growth, low unemployment and inflation reach Fed's 2% symmetric target… it is time for the Fed to return to conventional monetary policy-making of yesteryear. He added that he sees inflation moving over 2% but he is not worried and that it is quite normal for fed to eventually move to restrictive policies. [14 Sep 2018]

- Fed's Bostic said he agreed the Fed should be gradually moving rates higher, toward an estimated "neutral" setting, and that the process could continue for at least a "handful of quarters". But he added that the increases would not necessarily have to come on a quarterly basis and that he was not ready to commit to raising rates twice more this year compared to only on more time. [14 Sep 2018]

- Fed's Brainard said that the Fed has room to raise interest rates over the next couple of years without slowing economic growth. She added that stimulus from tax cuts and government spending under Trump lift short term neutral level of interest rates, a theoretical level of borrowing costs that allows investment and hiring to continue unimpeded in a healthy economy [13 Sep 2018]

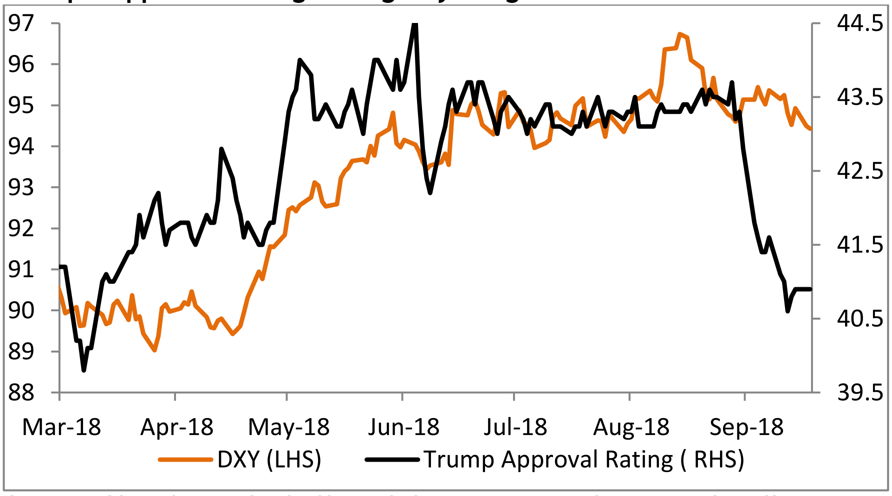
However a **dovish guidance from Fed may catch markets off-guard and see USD strength and UST yield taper off.** This should provide a breather for risk assets and high-beta FX. Recall that Powell's comments (no clear sign of inflation accelerating above 2%... gradual hikes likely appropriate if growth stays strong… there doesn't seem to be elevated risks of overheating) at Jackson Hole Symposium (24 Aug) suggest that gradual pace of tightening remains the appropriate policy stance for now and there was no indication of a step up in the pace of normalisation.

Further Unwinding of USD Net Longs Could Fuel USD Downside



Source: US CFTC, Maybank FX Research & Strategy

Trump's Approval Rating Falling May Weigh Further on DXY?



Source: Bloomberg, Real Clear Politics Trump Job approval poll average, Maybank FX Research & Strategy

FX Positioning Matters; Trump Polls Possibly Matters Too

CFTC positioning for non-commercial (speculative) shows markets modestly trimming net USD long exposure but current positioning remains well above 3m and 6m average levels. Further unwinding of stale USD longs could see a sharp move lower for USD. In addition, we are watching Trump approval rating and its relationship with the DXY - Trump poll falling may well be a political factor weighing on the USD.

Trading Play: Long INR, IDR, EUR, GBP vs. Short CNH, KRW, AUD

In summary, caution remains warranted on AXJ FX as trade war development remains highly fluid and ahead of the upcoming FoMC meeting (which could keep UST yields and USD supported).

Relative stabilisation in EM FX amid recent policy measures could favor tactical longs in IDR and INR vs. shorts in CNH and KRW within the AXJ space. Given the large sell-off this year and its respective high betas, a recovery in sentiment in the EM FX space could see IDR and INR retrace some of its earlier losses. Amongst the G7 space, we maintain our constructive outlook on EUR and GBP over antipodeans (AUD and NZD) amid monetary policy divergence and antipodeans' high sensitivity to trade war development.

Technical Thoughts on the DXY: Turn Lower is Compelling

DXY was last seen at 94.70 levels. Bullish momentum on weekly chart is waning while stochastics is falling. These suggest diminishing momentum for DXY bulls. On the monthly chart, the DXY created a gravestone doji candlestick for the month of August. This implies an interim top of the rise in DXY since Feb 2018 and strength is likely to fade going forward. We stand firm on our call to fade USD strength however near term strength likely as seen from daily momentum. Resistance at 95.5 (21 DMA), 96.50 (23.6% fibo retracement of 2011 low to 2017 high). Support levels at 94, 93.2 before 92 levels (38.2% fibo).

DXY (Monthly Chart): DXY Likely to Have Made an Interim Top

Source: Bloomberg, Maybank FX Research & Strategy

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