

Scotia Asian FX Update

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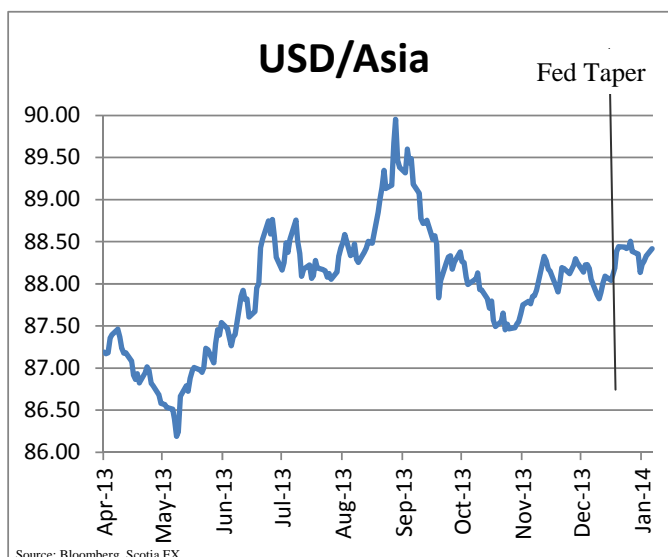
A NEW YEAR FAVOURS DIFFERENTIATED ATTITUDES TOWARDS ASIAN FX

- USD should do better at outset of year vs. most Asian FX as markets price in better data and supported Treasury yields.
- Focus will eventually return to easy US policy settings going forward, which will ease sting of higher yields.
- Political risk continues to drive THB weakness, with no respite in sight.
- INR stabilizing but risking lower in our view as monetary policy outlook is clouded.

Happy New Year. In our last publication on December 16th, the week of the FOMC meeting, we had noted that a not insignificant risk existed for a Fed taper in December given the trend in US economic data, something that was being reflected in shorter term yields. Indeed a taper is what the market received as a Christmas present from the Federal Reserve in a tapering of 5bn a month in MBS and the same amount in Treasury purchases. What actually surprised us a bit was that there was no decision to alter the forward guidance component (i.e. a lower unemployment threshold) as we assumed the Fed would look to counteract any negative impact on bonds from an earlier than expected (relative to consensus) taper.

While this did not happen, the Fed reaffirmed its expectation for the Fed funds rate to remain “exceptionally” low at least as long as unemployment remained above 6.5% and inflation projections (on a between 1 and 2 years ahead basis) remained no higher than 2.5%. US yields have remained generally higher since the policy decision, which has supported USD/Asia to some degree, keeping most of the Asian currencies (save for CNY and KRW) trading a bit more softly since Fed decision. However Asian weakness due to Fed factors has not been as notable as could have been the case (remembering the summer months of 2013) as the focus shifts to the duration over which Fed funds remains very low.

Stepping back and looking at the macro picture, easy monetary policy is still well in effect (from both the US and Japan) which should provide better support for assets during periods of strong risk aversion. However, given that the focus remains on generally more positive economic results across the G3, the direction of policy should still be seen as “less” easing over time, and thus impact the ability of EM to sustain gains of previous years (at least before the summer of last year).



The performance of USD/Asia mimics this as the directional trade has been far from one-way, and has not necessarily been only moving higher since the Fed decision (see chart). The USD outlook still looks a bit better against Asian currencies with external account risks either across current account, portfolio accounts, or both (INR, MYR, IDR). Essentially, we have a still supportive risk environment thanks to easy policies and a better outlook for G3 growth at the outset of the year, but less directional favour in EM nations that can no longer rely on the view for continually easing US policy to bolster their fortunes.

USDTHB • Political tension remains a huge weight on THB as the SET continues to face pressure on the back of ongoing efforts by the Thai government’s opposition supporters to block efforts by candidates to register themselves for the upcoming election. This would throw into doubt the legitimacy of the outcome of the election as 95% of seats in the Thai lower house must be filled in the event of an election (94% of seat registrations have been completed). The opposition protest leader Mr. Suthep is planning to hold a large scale protest on January 13th, keeping the political tensions in the country well stoked and negatively impacting Thailand’s economy (not least through tourism). We continue to target higher in USDTHB after our end of year target was achieved, and our end of Q1 target of 31.00 has also been surpassed. While political tensions remain well stoked, there will be likely little respite for the baht.

USDCNY• While Chinese economic expansion has been indicated to be easing a touch by the PMIs, CNY has been supported by stronger fixings. Spot market volatility remains fairly restrained on an intraday basis, while option volatility has collapsed since late December to reflect lower intraday spot levels and seasonality factors. External accounts and political will remain two key features that support RMB bullishness and we continue to support long positioning in the currency at the outset of the year.

USDINR• Data received since mid-December has not exactly been overly supportive as India has received higher inflation results and less robust manufacturing sector indications from the PMI (which saw the December read drop from 51.3 to 50.7). A lack of movement in the repo rate at the December 18th meeting indicated that the RBI is in wait-and-see mode (the market expected a hike of 25bp), and a concern with the industrial sector and the lack of upside in the area. There was a bias evident in the policy communication to favour a rate hike, however economic weakness was a constraint and there were potentially temporary food shocks relevant for WPI which may work itself through in the near term.

The INR has proven to be reasonably robust to the Fed's taper and has been trading in a fairly tight consolidation range. We still favour the upside in INR given the inability of the RBI to easily navigate the economic dynamics currently at play. We feel that growth hasn't shown us anything that would result in a sustained or impressive upswing (capital investment dynamics remain weak), though the election this year could bring some solid sentiment shift under a strong BJP-led government mandate, should that outcome be realized. We feel that INR strength on the back of such an electoral outcome would be more sentiment driven portfolio flow related, and we will continue to look at the dynamics of the external accounts for real fundamentals-related INR improvement. This would mean an improved trade position NOT related to tariff-induced gold import reductions only, but also to better sustained export growth.

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