Asia Monthly Update October

Not without challenge

Amy Y. Zhuang, 27 October 2016

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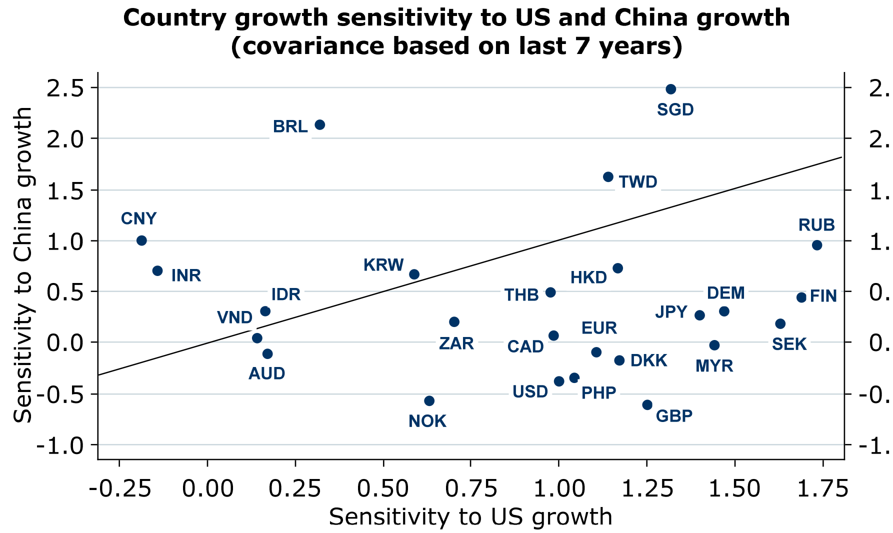
Executive summary

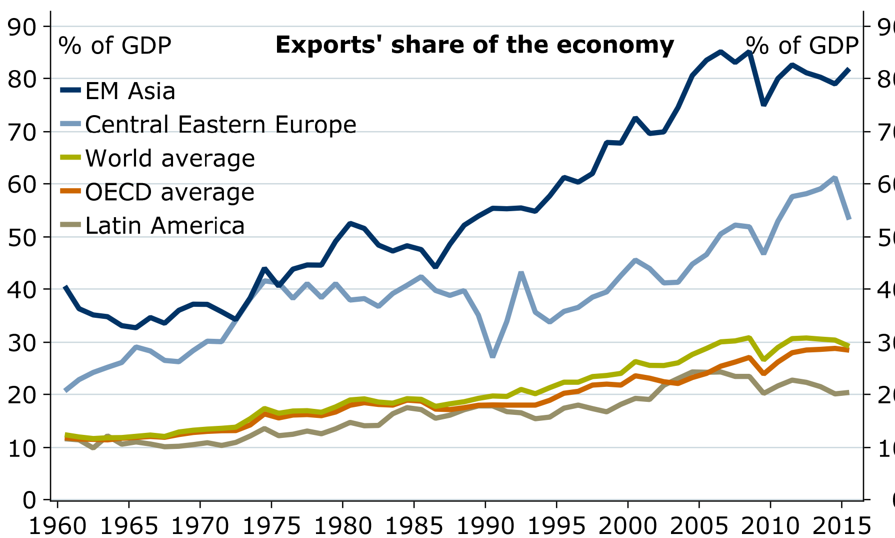
- **Asian FX did not see much gain against the USD in October.** It was mostly due to a stronger USD rather than a weaker local currency
- **We expect the road just ahead of us to be bumpy for all EM FX but particularly for Asian FX**, which faces double whammy of a stronger USD and a weaker CNY. The latter has seen rising influence on Asian FX. Moreover, Asian FX is not as undervalued as LatAm and CEE FX, which have lost 60% since 2013. Thus, their room for rebound is also smaller
- Asia remains the source of future growth but **the region faces challenges** amid weak global demand and rising protectionism, and not least rising risk of a hard landing in China
- Many Asian countries share similar advantages, such as young and abundant labour and underinvestment in infrastructure and manufacturing. **Each government's strategy of boosting domestic demand via infrastructure investment depends on their ability to reduce bureaucracy and improve business climate.** For most of these countries, there are still a far way to go
- Most vulnerable to further USD strength: KRW and SGD
- Least vulnerable to further USD strength: IDR

Asia: Growth not without challenges

- Most people see Asia as the future growth engine. With an expected average growth of 6%, it will undoubtedly be the region with the highest growth. However, this does not mean that Asian economies are not facing headwinds.
- Asia has become more dependent on China and less on the US. The implication is not only downward growth pressure following China's expected slowdown in the years ahead, but if China experiences a hard landing, and this risk is rising given the large debt outstanding, the Asian countries will take the hardest hit.
- On a consolidated basis, Asia is more reliant on exports than any other region. The rising protectionism in the US, Europe and elsewhere is putting Asian countries in a vulnerable position.
- This has caused many Asian governments to turn the focus toward infrastructure investment and domestic demand. They key to success is the government's ability to liberalise and improve business climate.



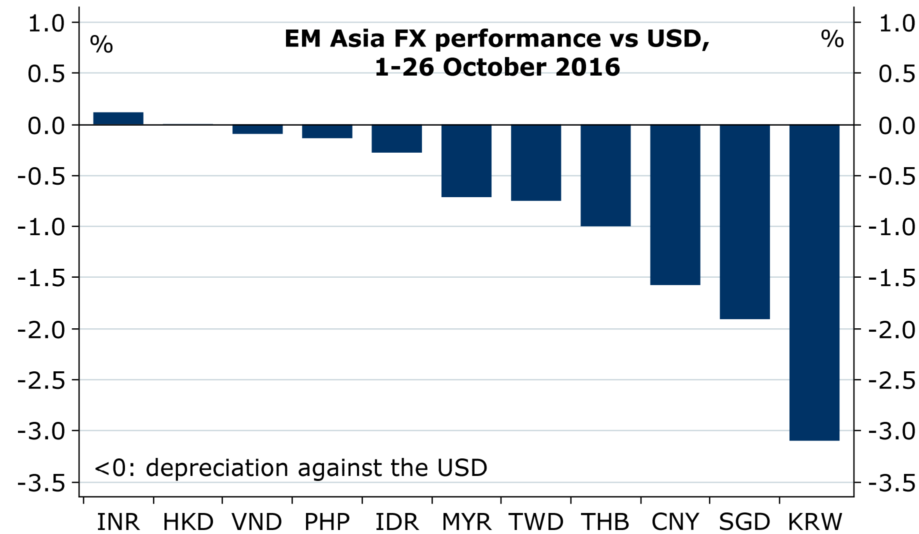
Source: Nordea Markets and Macrobond



Source: Nordea Markets and Macrobond

Asia FX: The dollar story

- October has not been a good month for Asian FX. Nearly all eleven currencies, that we follow, have lost ground against the USD. It was mostly due to a stronger USD rather than a weaker local currency. Correlation with the dollar index is close to all-time high.
- Given that the market will continue closely watch the events in the US in the coming two months, including the election on 8 November and the FOMC meeting on 15 December, the USD dominance is likely to persist. We expect a stronger USD, which implies downward pressure on Asian FX in at least the coming 3-6 months. It seems that the KRW and SGD are most vulnerable to further dollar strengthening.
- For 2017 we see a good chance to perform for FX in Latin America and Central Eastern Europe because many of them are heavily undervalued after the 60% fall since May 2013. Asian FX have fallen by only 15% during the same period and does not face the same room of rebound.



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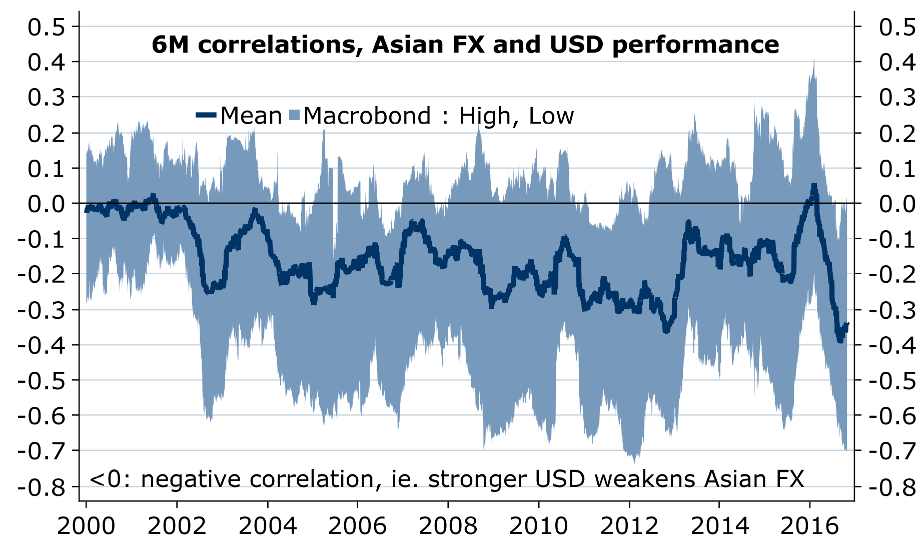

Source: Nordea Markets and Macrobond

China: Growth stabilisation not sustainable

- The GDP growth for Q3 was as expected, 6.7% y/y. The stable momentum was supported by accommodative policy, which is not sustainable.
- We expect the GDP growth to underperform in Q4 and next year because the economy will lose two out of three pillars of support: the monetary and housing market.
- Because the monetary policy has not been eased at the same pace as in 2015, its support to growth will start fading away around year-end.
- Moreover, the housing market will start cooling down due to tighter regulation. During the past two months, nearly all tier 1 and 2 cities have launched tighter restrictions against house purchases. Some of the cities have tightened policy several times. This will dampen construction activities next year.
- Nonetheless, we see a small likelihood for a sharp slowdown because of supportive fiscal policy that will keep activities at a certain level.

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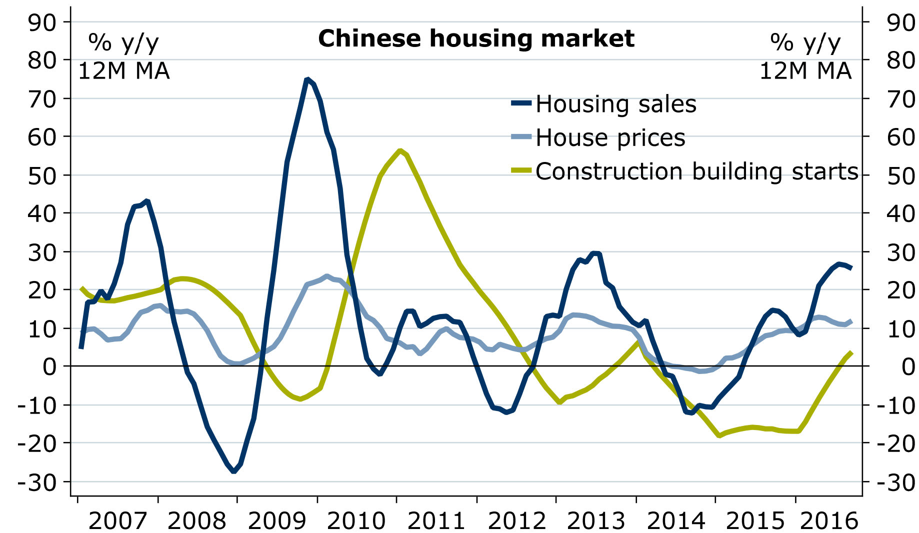
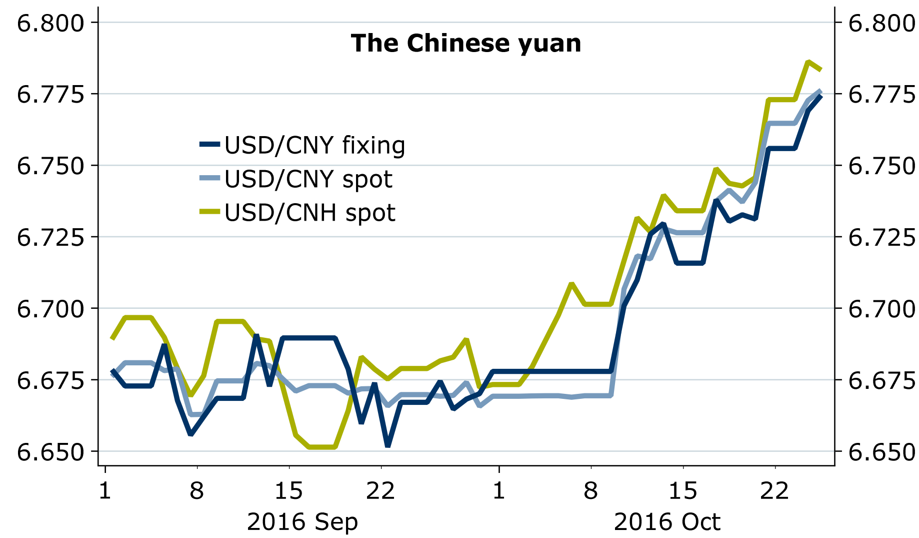


Source: Nordea Markets and Macrobond

CNY: A market-driven weakening

- During the past two weeks, the CNY, as well as the CNH, has weakened by 1.5% versus the USD.
- This unusually large loss was driven by changes in the major currencies. The PBoC's new goal is to maintain stability in the trade-weighted exchange rate, represented by the CFETS RMB index, containing 13 currencies. If the spot CNY appreciates against any of the 13 currencies in one day, the PBoC has to weaken the CNY against the USD (with a weaker fixing) the day after to keep the CFETS RMB index unchanged. Our model, using this approach, is able to explain the latest changes in the fixing rate.
- The market has so far had muted reaction to the CNY weakening. The implied volatility remains low and there is no significant depreciation pressure. As a result, the PBoC has not felt the pressure to intervene.
- Nonetheless, the risk of a sudden shift to devaluation expectation and capital outflows are not off the table.



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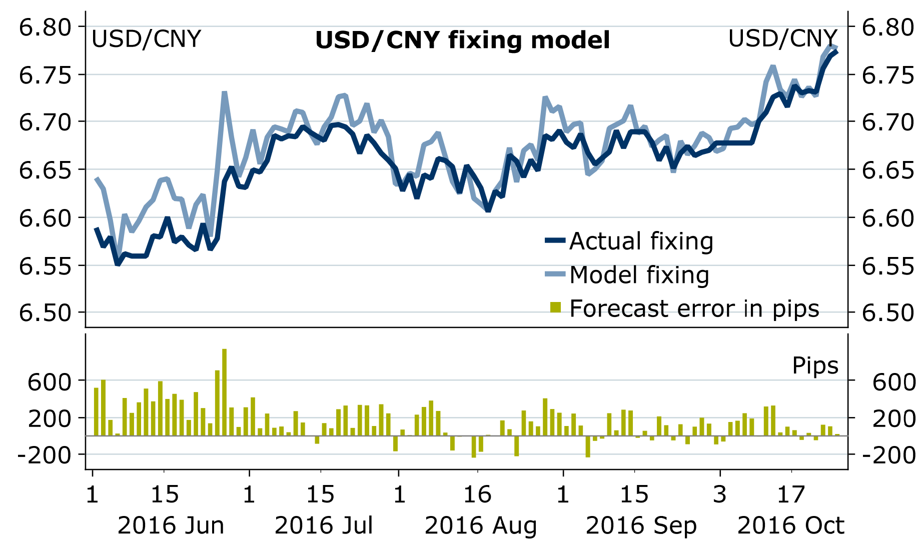
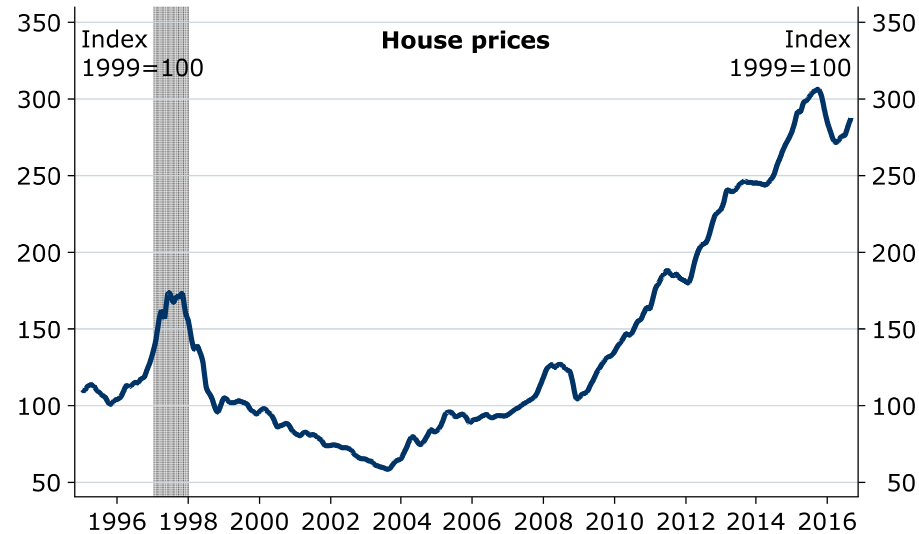


Source: Nordea Markets and Macrobond

HKD: Hidden risks

- The HKD has remained flat in October despite the large weakening in the CNY/CNH. The strength came from capital inflows from mainland China, which are no longer pouring in to the equity but now to the real state market.
- The large interest in Hong Kong's property market came after mainland China tightened regulation on housing purchases. In addition, the depreciation renminbi made offshore assets more attractive.
- This has caused house prices in Hong Kong to rebound after six months' decline and the housing bubble is growing again. Given the bubble is already larger than during the Asian crisis, it is one of the biggest risk to Hong Kong.
- We expect the HKD to stay strong versus the USD, and the deep discount, until the market turns on risk-off mode. The biggest risk is if the depreciation expectation on the CNY returns. In such a case, the HKD may be used as a proxy to be short.



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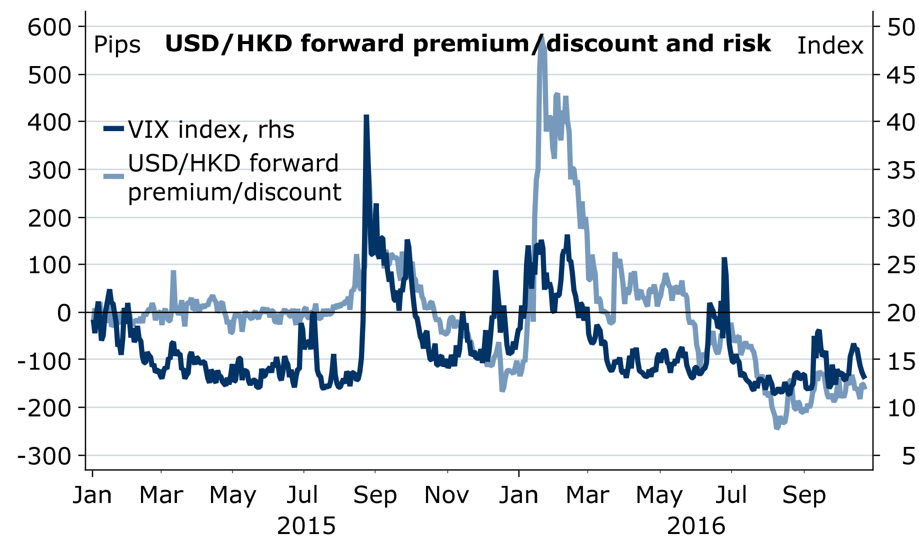

Source: Nordea Markets and Macrobond

India: Dovish RBI is not enough

- In early October, the RBI unexpectedly cut rates by 25bp to 6.25%. It was the first monetary policy meeting with the six-member committee and the new Governor Urjit Patel.
- This surprise move was to encourage more bank lending, which currently grows at 9% y/y, the lowest pace in 12 years. But lower rates alone is insufficient to encourage more lending.
- Other changes include improving the monetary policy transmission mechanism. Since 2015, the RBI has cut rates by 175bp but banks have only cut the effective lending rates by 60bp, so borrowers have not seen much lower costs.
- Moreover, the system requires banks to invest a large proportion of their assets in government securities and leave less resources available for lending.
- Finally, rigid bankruptcy law until recently have made it difficult for banks to recognise and write off bad loans.

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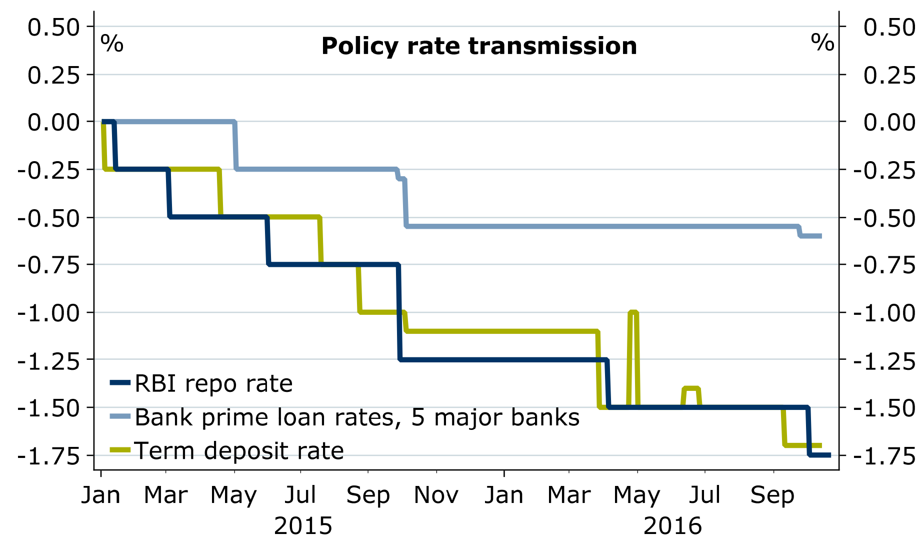
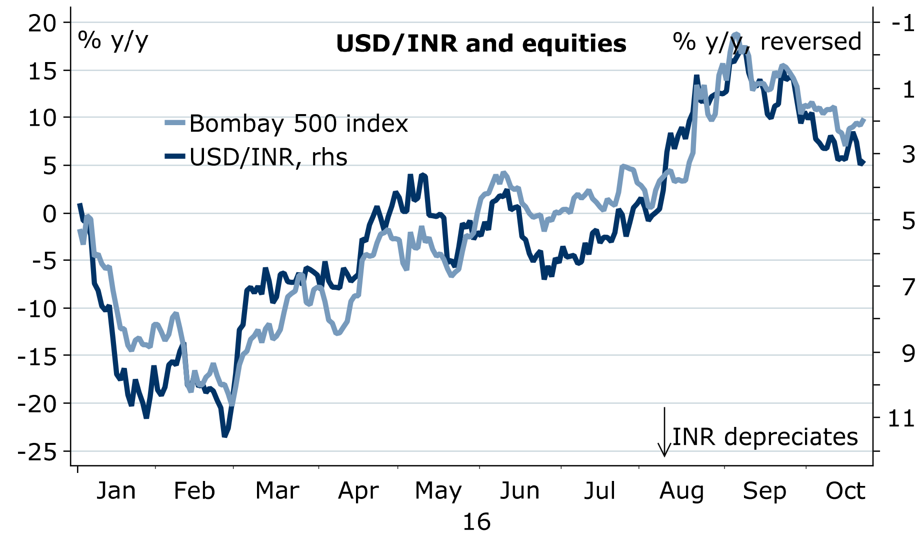


Source: Nordea Markets and Macrobond

INR: near-term downside

- During the past month, the INR has remained to be risk-driven as it has been during this year. The less good performance in the local equity market has limited the upside of the INR.
- The large capital inflows, seen over the past few months, have stopped. Capital is not flowing out but no new inflows have occurred.
- We expect the risk-driven movement to continue for the rest of this year. It means that if risk sentiment turns around toward risk-off, whether triggered by the US election or the possibility of a hard Brexit, the INR faces some downside risks.
- The RBI was seen to have intervened in the market in the last few weeks, as the INR is approaching a record-weak level. The RBI is likely interested in maintain stability in the INR.
- Due to India's bright growth prospect and continue progress in reforms, the INR remains one of our favourite EM currencies in the longer term.



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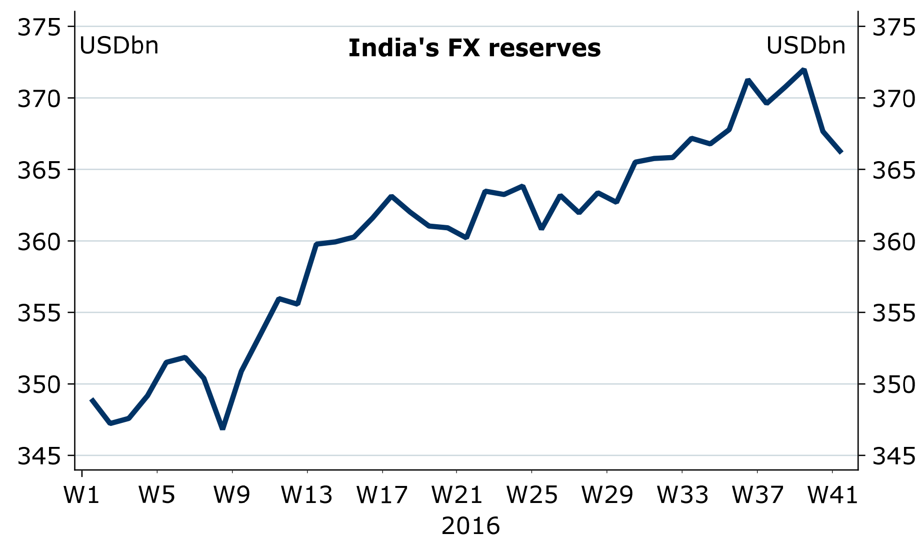
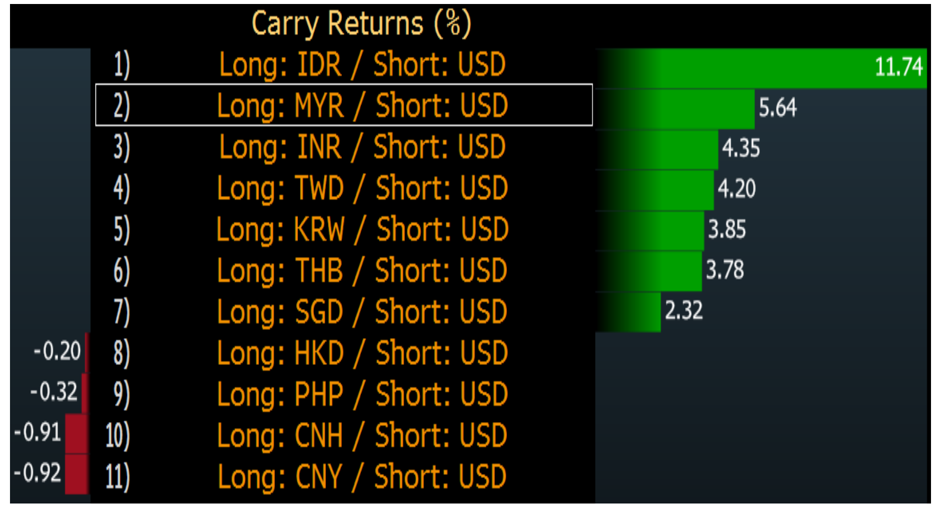
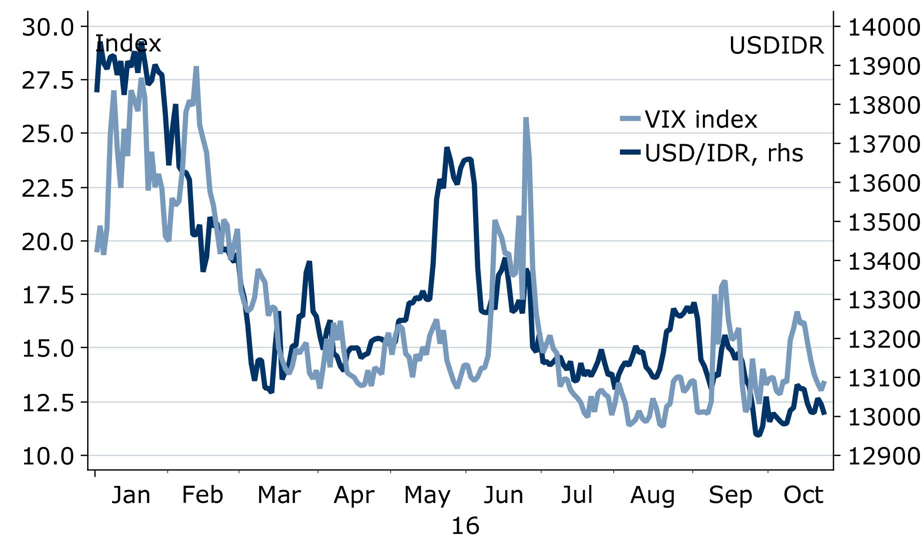


Source: Nordea Markets and Macrobond

IDR: Benefiting from the carry hunt

- On 20 October, the BI cut interest rate again by 25bp to 4.75%, the sixth this year. Given the low growth projection and modest inflation, there is room for one more cut in the near term.
- Lower borrowing rates is a crucial part of the government's plan of kick-starting an investment boom in infrastructure and manufacturing. Bank lending growth is very low at 12% y/y and total credit to GDP ratio is falling behind the other Asian countries.
- Despite lower rates, the IDR still offers attractive carry return in Asia. The year-to-date carry return for longing the IDR and shorting the USD is nearly 12%, far higher than the others.
- Risk-on sentiment have drawn capital inflows into Indonesia and pushed the USD/IDR lower. Although the currency pair faces some downside risks from the US election and Fed rate decision in December, we expect the attractive carry to provide a floor for the IDR.

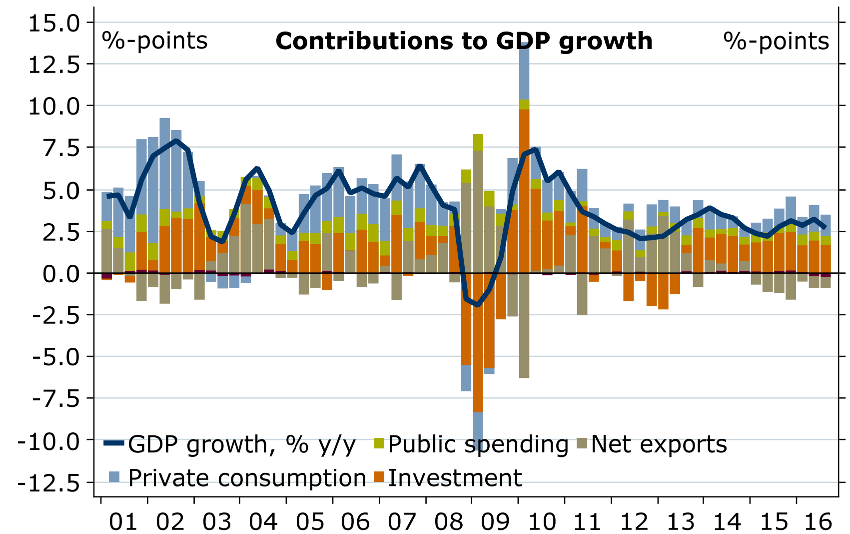




Source: Nordea Markets and Macrobond

KRW: Samsung-hit

- South Korea's GDP growth decline in Q3 from Q2. Growth drivers are the same as the last two years. Household consumption and investment remain as the primary drivers and net exports once again dragged down growth.
- Given the continued slow pace of recovery and persistently low inflation (around 1% that is far lower than the target of 2%), the market sees a chance for the BoK to cut rates in the coming six months. We are a bit more skeptical, as the BoK has expressed concerns about the large and rising household debt, fuelled by low rates.
- The KRW has lost 3.4% against the USD so far in October due to two main factors: USD strength and the Samsung Note 7 debacle. The latter caused Samsung's shares to plunge 10% in a few days and a serious jiggle to investor and consumer confidence.
- Longer out, the slowdown in China, subdued global trade growth and missile threat from North Korea pose a downside risk to the KRW.



Source: Nordea Markets and Macrobond

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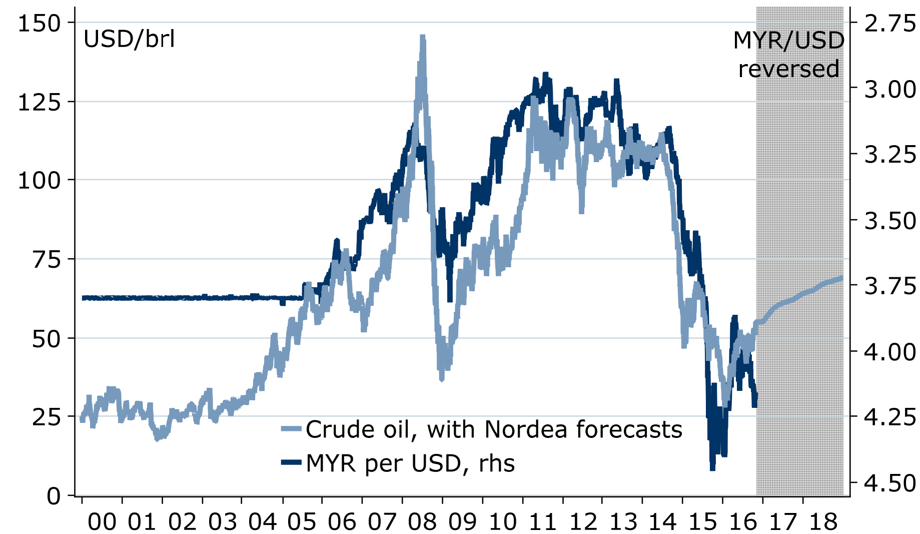
MYR: Opposite driving forces

- After weakening nearly 2% against the USD, some of the loss in the MYR has retreated. The rebound in the ringgit came despite a broad-based strength in the dollar and that the oil prices have fallen 5% in the period, both should have weakened the MYR.
- Sentiment in Malaysia improved in mid-October as the government announced a smaller expected deficit in the new budget. The share of oil-related fiscal revenue fell from the peak of 20% to only 8% now. This will reduce the MYR's sensitivity to the oil prices, especially if OPEC fails to reach a supply cap on 30 November. The latest news revealed obstacle to reach a deal.
- In addition to the OPEC meeting, we see the Fed December meeting as another event that could trigger some downside to the MYR.
- On the positive side, the sharp depreciation of the MYR since 2014 made it undervalued to fundamentals. This should limit the downside.



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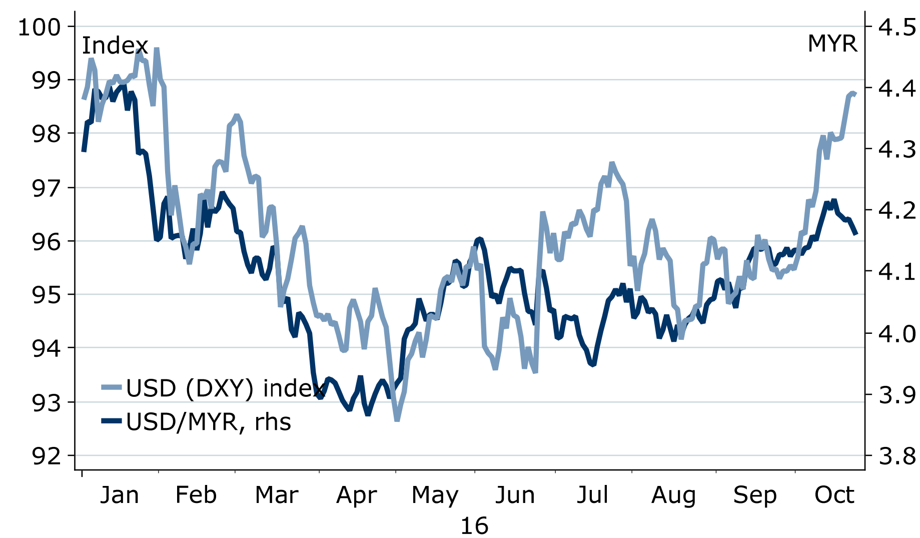
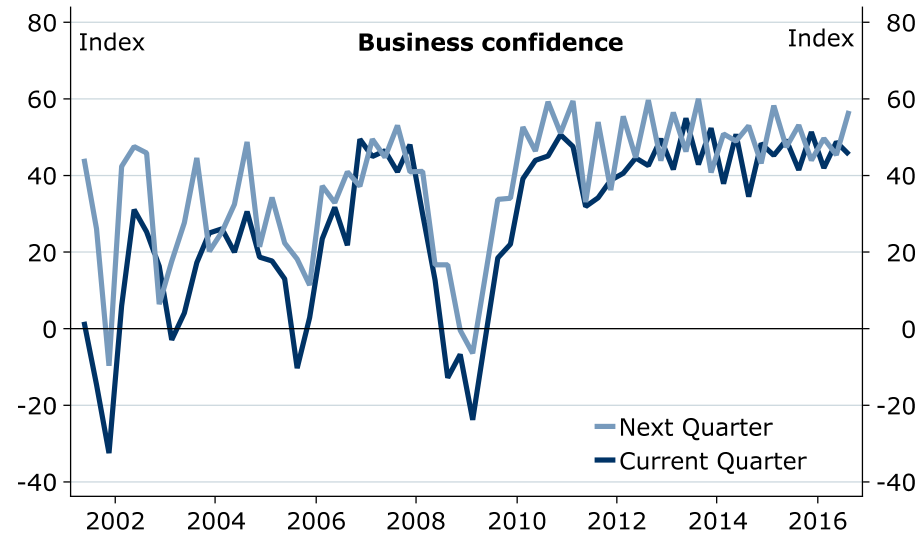


Source: Nordea Markets and Macrobond

PHP: A political gamble

- The sharp weakening of the PHP during the past few months was primarily due to the uncertainty political outlook following President Duterte took over. The political scene continues to dominate the Philippines financial markets.
- During the recent visit to China, Duterte's bet on benefiting from China's rising global influence potentially at the cost of breaking up the long history of alliance with the US became clear.
- Duterte announced his military and economic "separation" from the US. Although he tried later to soften the tone, it has caused concerns and pushed for more capital outflows.
- At the same time, 13 bilateral trade and investment deals were signed with China. Duterte's humble attitude to Beijing has pleased the Chinese but has raised eyebrows in Philippines. Even so, both business and consumer confidence continued to rise for the future. The expectation is that closer economic ties with China would benefit the Philippines.



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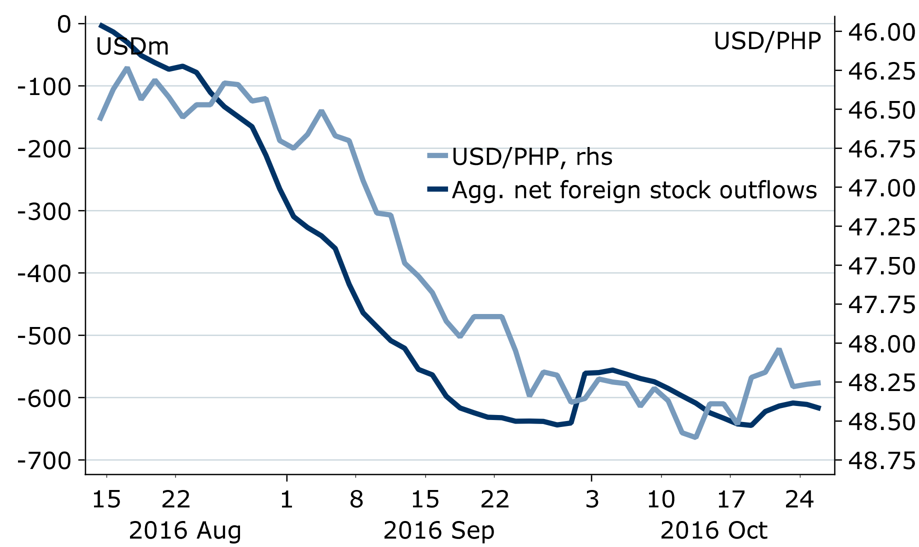


Source: Nordea Markets and Macrobond

SGD: Dollar-driven

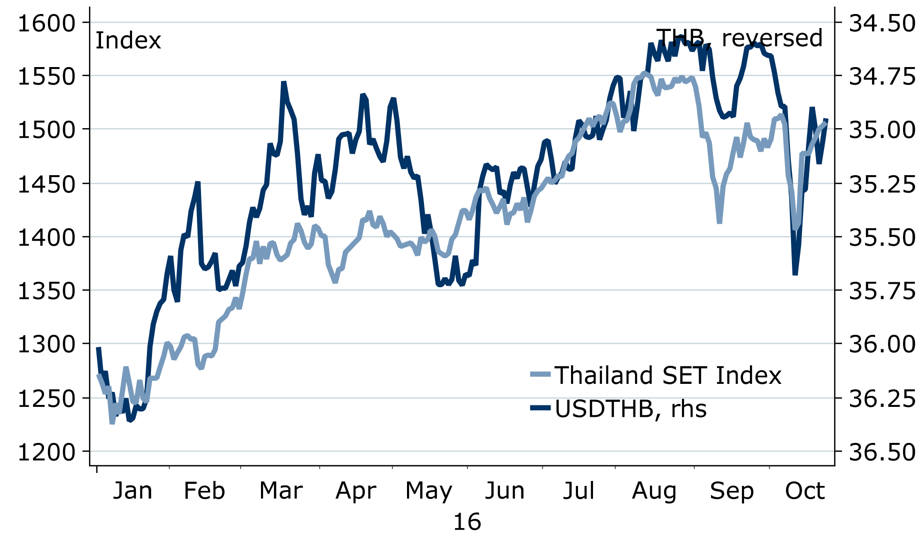
- Being a small open economy that is reliant on delivering services to global companies, the SGD is highly correlated to the USD. Currently it's 6-month daily correlation with the DXY index is 75%, higher than any other Asian FX.
- Events in the US will remain a key driver for the SGD for the rest of this year, including the US election on 8 November and the FOMC meeting on 15 December. The USD is likely to continue rising and pose more downside risks to the SGD.
- But on the other side, the SGD appear very oversold now, so we may expect a sharp rebound in the SGD if the USD takes a pause from strengthening.
- Domestic macro momentum remains subdued. Q3 GDP growth plummeted from 2.2% to 0.6% y/y, the lowest since 2009 and outside of the MAS' comfort zone. The unexpectedly low growth again raises the possibility of a MAS easing in April next year.

Source: Nordea Markets and Macrobond

Source: Nordea Markets and Macrobond

THB: There and back again

- The King's death has not only not been a catalyst for a massive sell-off in Thailand, the announcement gave an immediate rebound and made the THB to correct for the weakness it has seen in the days ahead of the passing.
- The crown prince was appointed to become the new king. Although his unpopularity has caused some to fear instability, the military-led government is most likely to keep strong domestic control and prevent any turmoil. We expect the THB to be modestly affected during the transition and external risks, such as the US election and the FOMC meeting. If capital outflows speed up, the BoT will very likely intervene to avoid excessive volatility.
- The economy is still slowly recovering but the service sector may face some headwinds due to the one-year mourning period, which could potentially hit the tourism industry, as the country is supposed to keep a low key.



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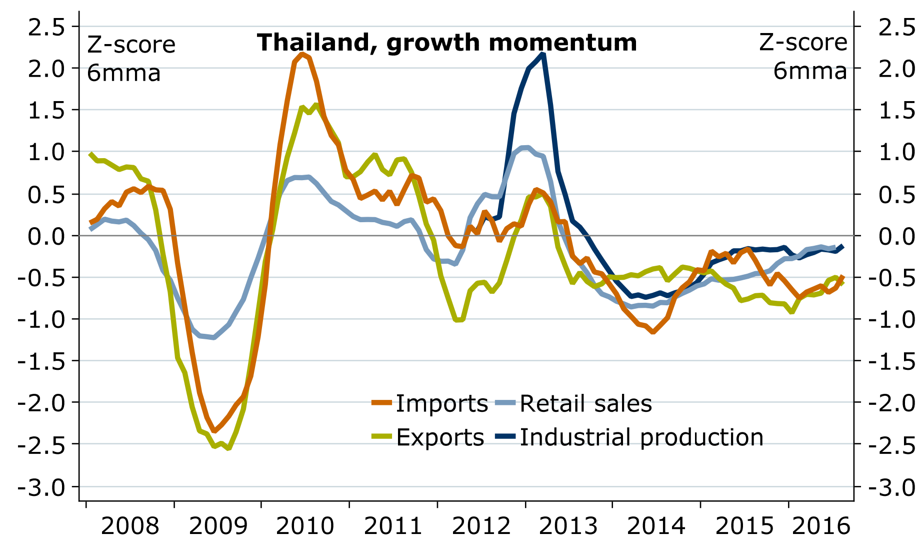
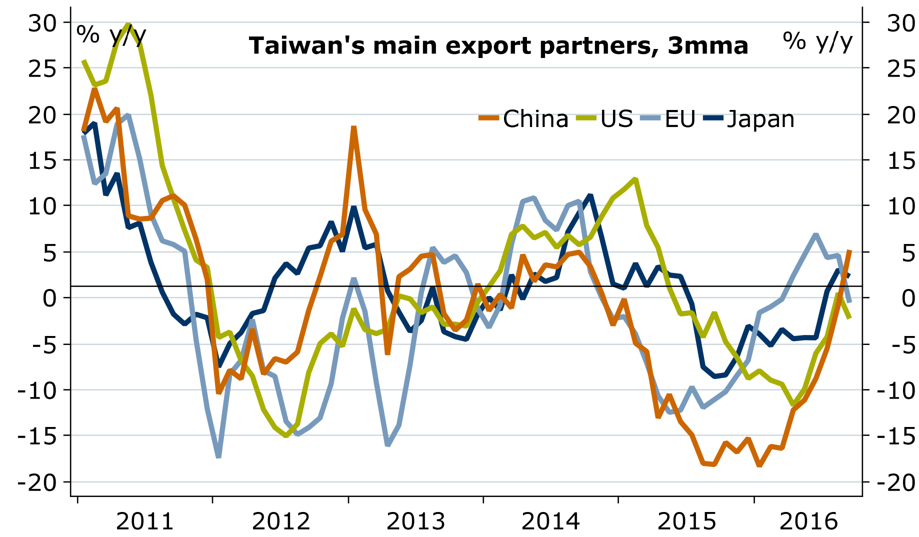


Source: Nordea Markets and Macrobond

TWD: Downside not over

- Taiwan extended its growth recovery from Q2 into Q3. Industrial activities have rebounded. Although its exports to US, EU and Japan continued to contract, it has recovered to China. Given China is by far Taiwan's largest export destination, it has helped limiting the downside for the overall exports.
- Samsung's debacle may provide some tailwinds to Taiwan's electronic products in the months ahead. However, Taiwan's economy will take a hit in the longer term, following China's continued slowdown. Moreover, Taiwan is in tough competition with Japan, Korea and increasingly China, all three countries trying to keep their currencies down. For this reason, the central bank has a bias towards weaker TWD.
- In the very near term, capital inflows may keep in the TWD range-bouncing but we see rising downward pressure from not only a stronger USD ahead of the December FOMC meeting but also weakness in the JPY, KRW and CNY.



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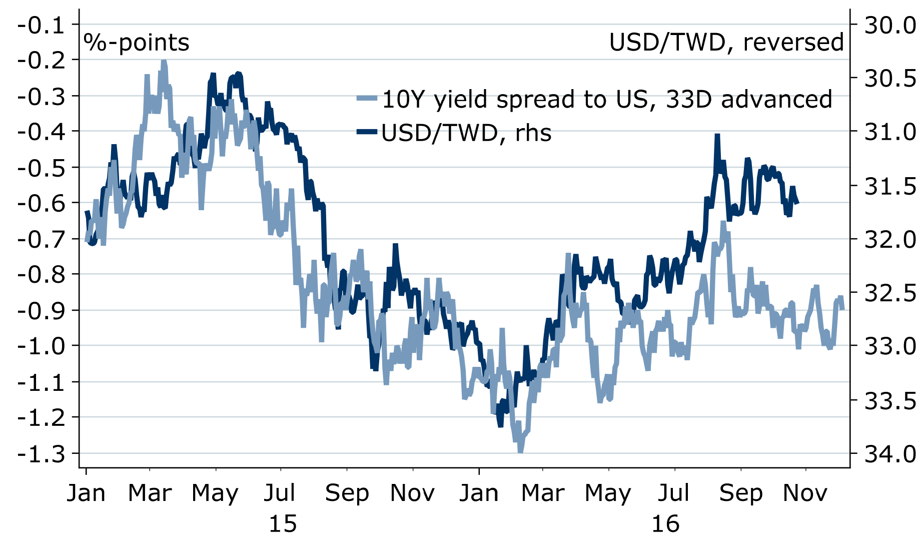

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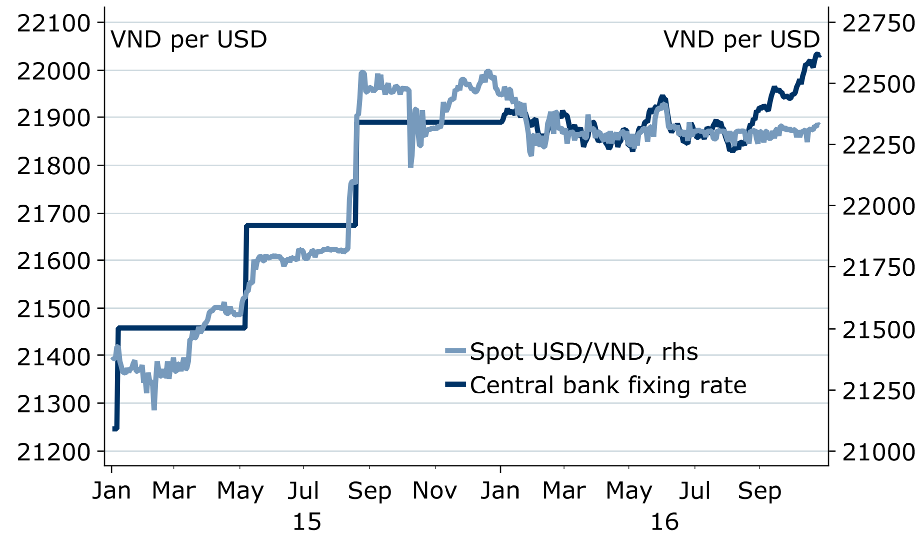
VND: Divergence

- Since January Vietnam has adopted a market-based approach in setting the fixing rate for the USD/VND, so it can change daily according to market movements. This has the advantage of preventing accumulated pressure on the VND. This advantage is being tested now.
- Since mid-August, the central bank started to adjust the fixing rate higher following the USD strength. However, the spot rate has failed to follow, even it has followed the fixing guidance closely this year. The government's plan with boosting the FX reserves, which cover less than 3 months' imports, will likely push the USD/VND higher. It has added USD 11bn so far this year.
- Economic momentum remains solid, with both manufacturing output and exports expanding steadily. The long-term prospect remains bright given the government's liberalisation of the economy. It has recently announced that it will divest VND 67tn (USD 3bn) from SOEs in the coming five years.



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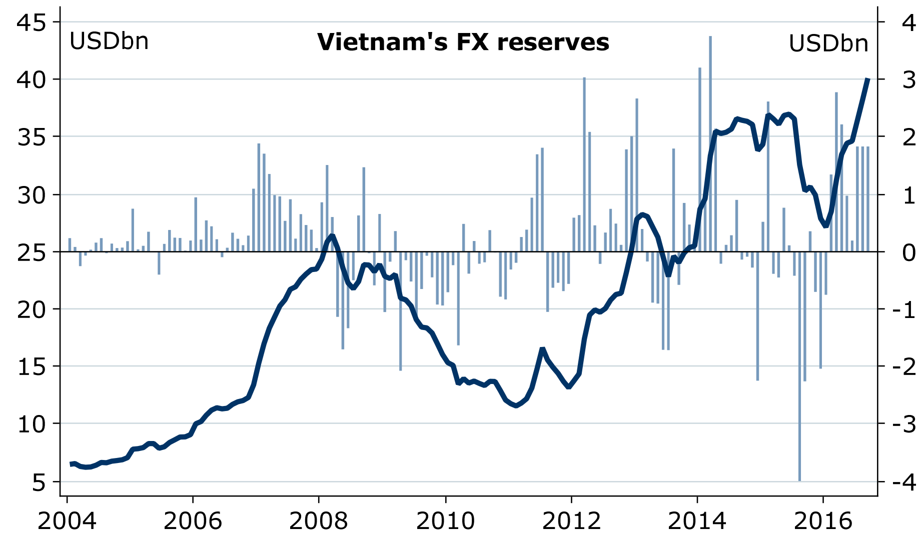

Source: Nordea Markets and Macrobond

Nordea FX forecasts

Exchange rates vs. EUR

	27/10/2016	3M	30/06/2017	31/12/2017	31/12/2018
EUR/USD	1.09	1.10	1.05	1.10	1.15
EUR/JPY	113.86	114.40	113.40	121.00	128.80
EUR/DKK	7.44	7.45	7.45	7.45	7.45
EUR/SEK	9.72	9.60	9.40	9.00	8.80
EUR/NOK	9.02	8.90	8.70	8.50	8.50
EUR/GBP	0.89	0.87	0.84	0.82	0.80
EUR/CHF	1.08	1.10	1.12	1.13	1.15
EUR/PLN	4.33	4.40	4.30	4.20	4.10
EUR/CZK	27.02	27.00	27.00	26.75	26.50
EUR/HUF	309.35	310.00	310.00	305.00	300.00
EUR/TRY	3.37	3.30	3.20	3.10	3.00
EUR/RUB	68.56	71.50	67.20	69.30	69.00
EUR/ZAR	15.16	15.95	14.96	15.40	14.95
EUR/CNY	7.39	7.43	7.25	7.59	7.88
EUR/INR	72.94	77.00	71.40	73.70	74.75
EUR/BRL	3.42	3.74	3.52	3.58	3.57
EUR/MXN	20.49	19.80	18.90	18.70	17.25

Exchange rates vs. USD

	27/10/2016	3M	30/06/2017	31/12/2017	31/12/2018
USD/JPY	104.42	104.00	108.00	110.00	112.00
USD/DKK	6.82	6.77	7.09	6.77	6.48
USD/SEK	8.91	8.73	8.95	8.18	7.65
USD/NOK	8.27	8.09	8.29	7.73	7.39
GBP/USD	1.22	1.26	1.25	1.34	1.44
USD/CHF	0.99	1.00	1.07	1.03	1.00
USD/PLN	3.97	4.00	4.10	3.82	3.57
USD/CZK	24.78	24.55	25.71	24.32	23.04
USD/HUF	283.72	281.82	295.24	277.27	260.87
USD/TRY	3.09	3.00	3.05	2.82	2.61
USD/RUB	62.87	65.00	64.00	63.00	60.00
USD/ZAR	13.91	14.50	14.25	14.00	13.00
USD/CNY	6.78	6.75	6.90	6.90	6.85
USD/INR	66.90	70.00	68.00	67.00	65.00
USD/BRL	3.14	3.40	3.35	3.25	3.10
USD/MXN	18.79	18.00	18.00	17.00	15.00

Nordea rates forecasts

Monetary policy rates

Country	Spot	3M	30.06.17	31.12.17	31.12.18
United States	0.50	0.75	1.00	1.25	1.75
Japan	-0.10	-0.10	-0.20	-0.20	-0.30
Euroland	-0.40	-0.40	-0.40	-0.40	-0.40
Denmark	-0.65	-0.65	-0.65	-0.65	-0.65
Sweden	-0.50	-0.60	-0.60	-0.60	0.00
Norway	0.50	0.50	0.50	0.50	0.50
United Kingdom	0.25	0.25	0.25	0.25	0.25
Switzerland	0.05	0.05	0.05	0.05	0.05
Poland	1.50	1.50	1.50	1.50	2.00
Russia	10.00	9.50	9.00	8.00	7.00
China	4.35	4.35	4.35	4.35	4.35
India	6.25	6.25	6.25	6.00	6.00
Brazil	14.25	14.25	14.25	13.50	12.50
Czech Republic	0.05	0.05	0.05	0.05	0.05
Hungary	0.90	0.90	0.90	0.90	1.50
Turkey	7.50	7.00	7.00	7.00	6.00

3-month rates

	Spot	3M	30.06.17	31.12.17	31.12.18
United States	0.88	1.00	1.15	1.40	1.80
Euroland	-0.30	-0.30	-0.30	-0.30	-0.30
Denmark	-0.19	-0.20	-0.20	-0.20	-0.15
Sweden	-0.52	-0.60	-0.60	-0.60	0.00
Norway	1.10	1.10	0.90	0.90	0.90
United Kingdom	0.39	0.40	0.40	0.40	0.40
Poland	1.72	1.70	1.70	1.70	2.25
Russia	10.54	10.30	9.30	8.35	8.00
Latvia	0.26	0.20	0.20	0.35	1.00

10-year government

Country	Spot	3M	30.06.17	31.12.17	31.12.18
United States	1.72	1.90	2.15	2.25	2.55
Euroland	0.02	-0.05	0.10	0.30	0.60
Denmark	0.17	0.10	0.25	0.45	0.75
Sweden	0.26	0.27	0.50	0.95	1.20
Norway	1.28	1.30	1.40	1.65	2.00
United Kingdom	0.99	0.85	0.85	0.95	1.15
Poland	3.07	2.90	3.05	3.25	3.50

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