Asia Strategy Weekly – A research report on Asian equities and fixed investments in a regional and global context

The theme for the week: Asian forex rate trends and equities

Weekly Report No. 2 Asian forex trends to stay supportive for equities 17/11/ 2021

The story for investors

Markets expect that the US Fed will hike rates in 2022 but as G2 are unlikely to do so, USD rate differentials will lead to a stronger USD. This result might be tempered by the negative impact on the US economy of higher rates. There is also the belief that Asian central banks actively manage their interest and exchange rates to maintain a weak currency policy in order to support exports or in some way "shadow" USD rates movements to control inflation. There is no evidence that Asian forex rates (bar HKD) follow systematically the movements of the USD. Thus Asian domestic interest rates do not systematically maintain USD differentials either, in order to support forex policies. The evidence for 2015-2021, which includes years with rising and falling USD rates, shows a wide variability of the relative "strength-weakness" of Asian forex rates to the USD.

Investment conclusions

Combined with our expectations that inflation trends in Asia in 2022 will be benign (see our Weekly No. 1, 7/11/2021) these conclusions on forex also support our expectations that Asian interest rates will not follow the Fed and, this, will help conditions for Asian equities to stay supportive. For some Asian exporters, the combination of low inflation and interest rates and, in general, relatively weaker forex trends will also be supportive. However this impact on exports will tend to be variable depending on the nature of exports and of their imports content. The forex rates, which remained relatively weak during the period examined here, included the CNY and KRW.

Forex dynamics versus the USD: Measure carefully...

We use here a simple technique to measure the relative strength-weakness of Asian currencies versus the USD. The USD index DXY is based on a basket of 6 currencies EUR, JPY, GBP, CHF, CAD, and SEK, with a rising value in index units indicating a stronger USD versus the basket. We graph the Asian exchange rates as local units per USD, but we rebase the values to 100 for January 2015. The date is important as a year later the Fed hiked rates till March 2019 and from then on rates were cut, thus giving a period of relative expected hikes and then, with the onset of Covid 19, unexpected cuts from March 2019 onwards. Figs. 1 & 2 show 8 Asian forex rates and DXY normalized over 2015-2021.There are two points to note in interpreting these two charts. **First**, the performance of these currencies is versus DXY and not versus the USD itself but to the basket of currencies representing it .Their movements can also indicate cross-rates trends,but always in relative and not absolute terms. In other words, all we can say here is that as the USD strengthened versus its basket, Asian exchange rates weakened or strengthened in relation to that basket and, hence, by extension to the USD. **Second**, as the base line here is Jan.2015=100, currencies over that line strengthen on down trend or weaken on uptrend, while DXY strengthens (up trend) or weakens (down). In Fig. 1 the TWD since 2017 stayed "strong" and below the 100 line .The rest of the currencies, including CNY, trended variably and above the 100 line. Note that if a currency moved parallel to DXY, then as DXY strengthened (up), an Asian currency moving also up

.....not all is what it seems with relative forex rates.

would indicate a weakening thus supporting the belief of the Asian "weak forex" policy. However the opposite movements, which happen frequently, do not support this belief, as when a currency strengthened (down) while the DXY weakened (down). Similar conclusions hold from the data in Fig.2. Here the currencies registered variable trends.

Fig 1: The, relatively, stronger Asian forex rates 2015-2021

Source: Bloomberg

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External balances, forex reserves and forex policies

All of the economies covered here are registering current account surpluses bar India, Indonesia and Thailand, the last also with falling reserves. Where there are rising forex reserves with current account deficits, these reflect net capital inflows, including loans where applicable. Except for the period of the 1997 "Asian Crisis" (which, incidentally, was neither Asian nor a crisis, but that is another story...) there have been no C/A driven crises in Asia. Indeed in the case of the PRC, the sheer size of its current account surplus plus forex reserves in excess of USD 3.0 trl, signal a global net lender, and net lenders don't go bankrupt! Hence the dynamics of external balances of Asian economies help shape the dynamics of their nominal exchange rates, but do not play the key roles they do in cases, such as Argentina, where the forex rates collapse under the pressure of external outflows.

FactBox: Summary of C/A, Forex reserves, Forex comments

Country	C/A	Forex reserves USD	Forex comment
China	Surplus rising	Rising 3,218	Capital controls
Hong Kong	Surplus rising	Rising 498	Pegged to USD
Taiwan	Surplus rising	Rising 546	Strengthened 2017-2021
S.Korea	Surplus rising	Rising 469	
Singapore	Surplus rising	Rising 419	Managed float
India	Deficit	Flattening 641	
Thailand	Deficit rising	Falling 246	
Malaysia	Surplus bottoming	Rising116	
Indonesia	Deficit flat	Rising 145	
Philippines	Surplus volatile	Rising 108	

The case of forex policies is a different issue while sticking to our claim that Asian central banks, except **Hong Kong**, do not deliberately manage their forex rates. Indeed we did not include Hong Kong in our analysis precisely because it is a single different case. In the case of **China**, repeated attempts by the US to label China as a currency manipulator failed under scrutiny from the IMF. China does have capital controls on capital flows but not on the trade and current accounts. **Singapore** manages its exchange rate against a basket of currencies of its major trading partners. Variations in the range of movements signal tightening or loosening monetary policy. The MAS has, therefore, no official interest rate.

Fig 2: The, relatively, weaker Asian forex rates 2015-2021

Source: Bloomberg

Where to from here?

The conclusions drawn from this analysis are not predictive in the sense that we can forecast the numerical values of Asian forex rates versus the USD. What the data show is that Asian exchange rates do not follow predictable patterns such as "when USD interest rates rise and the USD strengthens, then Asian forex rates will weaken in order to stay competitive."Their actual behavior is more complex and frequently counter-intuitive to expectations. The secular strength of TWD, especially when compared to the wider gyrations of KRW, and the overall strengthening trend of the CNY from 2019 to date are good examples. Given these considerations, and over the very unstable 2020-2021 period, we highlight the performance of the CNY, KRW, as weakening when the DXY strengthened and thus supporting export competitiveness. However it must be noted that, in periods of USD weakness as measured by the DXY, these currencies tended to strengthen, always in relative terms. But as 2022 is likely to be a period of USD strength the former trends will be likely to persist and, hence, broadly support exports.

The bottom line is that under the forex policies followed in Asia, local interest rates will not necessarily follow USD rate movements especially hikes. Thus Asian forex policies will be broadly supportive of equities and, selectively, of exports in a period of rising USD rates.

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