Theme #7: Japanese Takeaway

- **We expect sensitivity to the JPY and offshore portfolio allocation preferences will continue to drive Asian FX. We are long USD/KRW, USD/SGD & MYR/JPY.**

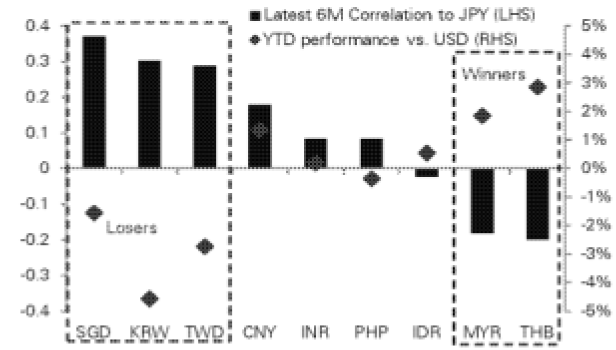
Asian FX returns this year have largely been driven by varying sensitivities to the JPY. Correlations to the JPY (first chart) differentiate the relative laggards – that compete for exports and portfolio flows with Japan – from the relative leaders – that are integrated into Japanese supply chains and should benefit from Japanese import demand, FDI, and potential QE-induced portfolio investment. With USD/JPY breaking into the triple-digit atmosphere, and a bulk of the "real" flow impact from Japanese policies yet to materialize, these divergent correlations remain the best guide to regional FX trends, in our view. In addition to the JPY, the outperformance of EM debt over EM equity fund flows has boosted debt-centric ASEAN FX over equity-centric North Asian FX. We believe this trend has legs but will become more selective.

KRW has the most to lose from JPY weakness. Competitiveness metrics such as export similarity indices point to a trade channel vulnerability. But the real pressure point comes from the portfolio channel. Earnings expectation downgrades for Korean companies and upgrades in Japan are driving relative equity market performance, resulting in flows into Japan and away from Korea. Importantly, an identical trend unfolded during the JPY weakness of 2004-07 (second chart). Politicization of FX may also drive further monetary easing and FX intervention in Korea. By comparison, TWD losses should be more subdued from here given weaker export competition with Japan, stronger equity inflows and central bank USD supply.

SGD is the purest USD beta in Asia. By virtue of its NEER framework, the USD TWI has consistently been the top driver of USD/SGD. Unsurprisingly then, the importance of the JPY to SGD has surged since the USD/JPY uptrend began in October. Importantly, a long USD/SGD view is predicated in principal on USD strength broadening across Singapore's trading partners. It is thus even compatible with S$NEER tracking near the top band, although this positioning makes the risk-reward that much more attractive.

MYR should outperform, given good inflow potential and a growing trade surplus with Japan. The status quo election result should sponsor portfolio rebalancing towards Malaysia. Equities have considerable scope to catch up to ASEAN peers, where valuations are now unattractive. IPOs should resume in force and could attract offshore interest. Bond allocations should pick up as underweights are covered (third chart) and as Thailand considers penalizing bond market access for foreigners. Malaysia meanwhile is unlikely to consider capital controls or a line in the sand on FX.

JPY has been a key driver of Asian FX performance

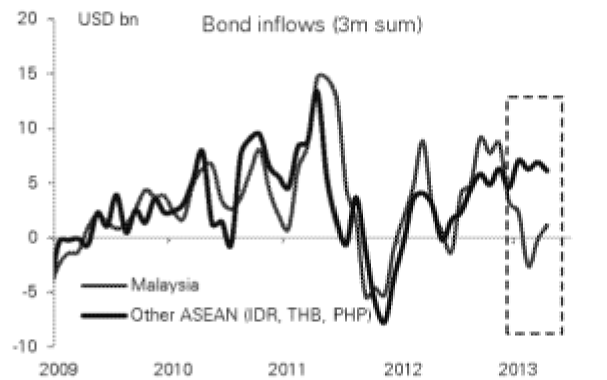


Source: Deutsche Bank, Bloomberg Finance LP

Equity flows move away from Korea and towards Japan during periods of JPY weakness

Source: Deutsche Bank, Bloomberg Finance LP

Portfolio reallocation to drive MYR outperformance



Source: Deutsche Bank, Bond flows data is collected from the respective country's official sources

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