



aversion and high volatility. However, these negative factors are also increasingly well-appreciated by markets, and arguably better reflected in valuations. This suggests that a singular focus on external vulnerabilities may not be a consistent way to make money in Asia this year. Indeed, as the Fed hikes rates, we believe the focus will increasingly shift to internal vulnerabilities and divergent monetary policy as drivers of performance.

Where are the relative weak links in Asia FX on these metrics? Based on a simplified measure of output gaps, nearly all Asian economies are forecast to grow below trend this year (Chart 4). The underperformance is starkest in China and Indonesia, but also affects a majority of developed North Asia (Singapore, Korea, Taiwan). The weakness in growth profiles should mean central banks remain dovish here. Another deterrent to Asia raising rates is the additional interest burden on households it would impose. In the QE years of low interest rates, many Asian economies saw a large run-up in household debt levels. The largest jumps took place in Singapore, Thailand and Malaysia. In Korea and Taiwan, outstanding debt levels were already high pre-crisis. Altogether, five major Asian economies now have household debt between 60-90% of GDP.

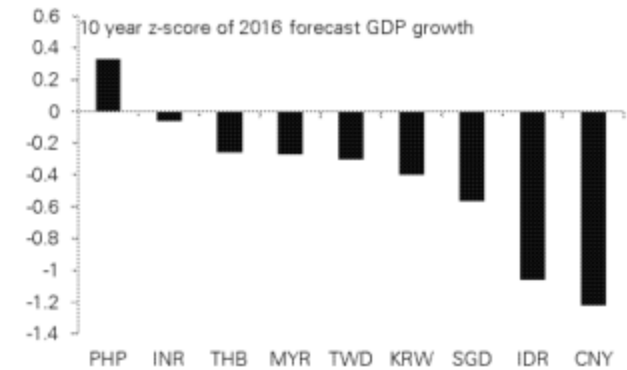
The transmission mechanism of internal vulnerabilities to currency markets, we believe, will take place through the rate differential channel where narrowing spreads between Asian and US rates will be magnified by Fed hikes. We find that the correlation of Asian FX to front-end rate spreads is the highest for the THB, TWD, CNY, MYR and KRW. In other words, if rates in these markets rise less than the US (or indeed fall even as US rates rise), compressing the rate differential, this is likely to be associated with weaker local currencies. The relationship is not as instructive for INR and PHP and is in fact inverted for SGD and IDR, where narrower rate differentials are associated with *stronger* currencies. For Singapore, this is a function of her currency-based policy framework which imposes uncovered interest parity: an appreciating SGD NEER pushes SGD rates below basket rates, and vice versa. While in Indonesia, we suspect this inversion captures the fact that the bond-FX relationship is dominated by foreign flows and credit concerns: offshore flows and lower risk premium drives lower local currency rates, but this is good for IDR.

While the externally still vulnerable MYR and IDR will continue to come under most pressure during stress periods; outside of these windows, USD strength could rotate more towards internally vulnerable currencies like KRW, TWD, CNY and THB from here.

Trades:

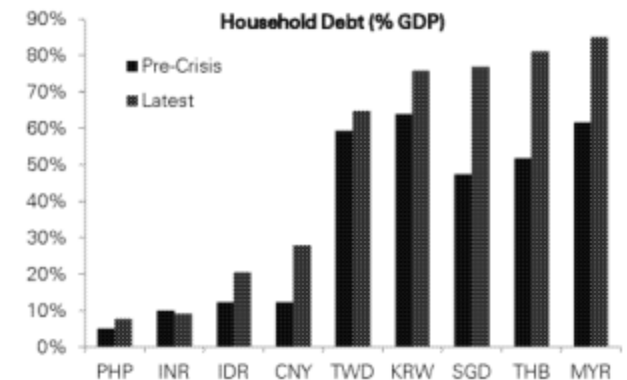
- Buy USD versus KRW (target 1300), TWD (target 35) and THB (target 40).

China's slowdown is the starkest, but most of developed North Asia in the same boat



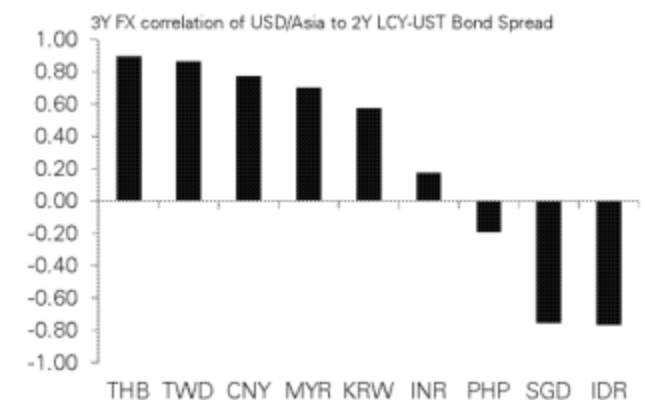
Source: Deutsche Bank, Bloomberg Finance LP, CEIC

Household debt has surged in Malaysia, Thailand, Singapore, and is at high levels in Korea and Taiwan



Source: Deutsche Bank, CEIC

THB, TWD and CNY have had the highest correlation to local rate differentials versus US



Source: Deutsche Bank, Bloomberg Finance LP

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